S. HRG. 101-1029

PROPOSAL FOR REGAINING ACTUARIAL SOUNDNESS OF THE FHA

HEARING

BEFORE THE

SUBCOMMITTEE ON
HOUSING AND URBAN AFFAIRS

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

THE ADMINISTRATION'S PROPOSAL FOR REGAINING ACTUARIAL SOUNDNESS OF THE FHA'S MUTUAL MORTGAGE INSURANCE FUND, AND TO EXPLORE ALTERNATIVES AND REFINEMENTS TO THAT PROPOSAL. ALSO TO HEAR THE VIEWS OF MAJOR ORGANIZATIONS REGARDING THE ADMINISTRATION'S PROPOSAL TO CHANGE THE FHA PREMIUM STRUCTURE

JULY 24, 1990

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PROPOSAL FOR REGAINING ACTUARIAL SOUNDNESS OF THE FHA

TUESDAY, JULY 24, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met at 10:15 a.m., in room SD–562 of the Dirksen Senate Office Building, Senator Alan Cranston presiding.

Present: Senators Cranston and D'Amato.

OPENING STATEMENT OF SENATOR CRANSTON

Senator CRANSTON. The hearing will please come to order. Good morning and welcome to the fifth hearing on the safety and soundness of the FHA program.

During this morning's hearing, we will consider the administration's proposal for regaining actuarial soundness and FHA's important mutual mortgage insurance fund. And we will explore alternatives and refinements to that proposal.

This is the first opportunity that the subcommittee has had formally to hear the views of major organizations regarding the administration's proposal to change the FHA premium structure. That proposal was submitted just as the Senate was immersed in its test preparation for action of the National Affordable Housing Act. And there's insufficient time for adequate hearings. Three separate proposals were under consideration on the Senate floor at that time.

Because I was concerned that the administration's proposal placed unnecessarily high barriers of families who were trying to buy their first home, I had developed an alternative for achieving actuarial soundness for the FHA fund. But what had kept the home buyers' up-front cash requirements essentially where they are under current law, the administration proposal would increase those cash requirements by about $1,200 on a $100,000 mortgage. By most estimates, that would take ownership out of the reach of 35,000 to 100,000 families.

Senator D'Amato believed the administration proposal did not go far enough to reduce FHA's risk, and he introduced a third alternative that would have raised the up-front cash requirements by about $2,400 on a $100,000 mortgage, or about double the increase that would result from the administration plan. The Senate decided to include a slightly modified version of the administration's FHA proposal in the Senate-passed housing bill.

I believe that was a proper decision for the Senate to make at that time. An issue as complex and sensitive and important as the FHA premium structure should not be decided in the rough-and-tumble of the Senate floor maneuvering. The language that was in the bill was agreed to in the negotiations that Senator D'Amato and I and others engaged in with the administration.

The House has yet to act on changes to the FHA premium structure. This may be an important issue to be resolved in the conference. As I stated on the Senate floor, I remain hopeful that Congress and the administration will be able to develop a solution that will regain long-term financial strength of the FHA in a way that will not make the goal of homeownership more unreachable for more American families.

I believe both objectives, actuarial soundness and expanded home ownership, can be achieved. I believe it can be achieved with alternatives to the administration proposal or refinements of the administration's proposal. I would be working now between now and the conclusion of conference to reach agreement on a proposal that will achieve both objectives.

The job before us will require that we put aside consideration to partisan advantage. There is no disagreement on the need to regain the long-term financial strength of the FHA fund. As the nation's premier support for home finance, all of us want to ensure the actuarial soundness of the fund. All of us want FHA to be adequately capitalized, and all of us want FHA to continue to serve low, moderate, and middle-income home buyers, particularly first-time home buyers.

The present danger to the FHA fund was created by 8 years of mismanagement under the Reagan administration, 8 damaging years marked by harebrained schemes to sell off FHA, by poorly conceived policy, by degradation of FHA staffing, by refusal to modernize FHA procedures, and by an enormously costly scandal.

One of the bitter legacies of the Reagan years is the result of the administration's proposals—that administration's proposal to create phony Gramm-Rudman budgetary savings, so-called, by charging the entire mortgage premium up front and then hiding the impact on the home buyers by allowing the premium to be financed within the insured mortgage.

Congress authorized the administration to adopt this up-front premium. However, because of concerns that this could increase the risk of default, Congress explicitly required HUD before implementing the change to make a formal determination that the up-front premium would not interfere with the actuarial soundness of FHA's mutual mortgage insurance fund.

Despite this requirement in the law, the Reagan administration in 1983 simply implemented the change without assessing the impact on FHA's actuarial soundness. We now are suffering the consequences of that action. FHA's premium has not been sufficient to compensate for other changes that the Reagan administration imposed upon FHA that have reduced FHA's staffing and lacks monitoring of an oversight of risky lenders.

We now must correct the damage done by the past administration, and we must do so promptly. One key question is the proper level of the FHA premium. Most believe that the premium should

reflect the risk incurred by the FHA funds. However, concerns have been raised of the administration proposal, which set a premium level that places the burden of correcting past problems unfairly on future home buyers.

Another key question is the structure of the premium. There is broad support in the Senate for structuring FHA's premium so as to create incentive for reducing the risk of default. However, some have expressed concern that the administration's proposal would have typical FHA home buyers paying not only a 3.8 percent up front, but also an annual premium of ½ of 1 percent effectively for the life of most mortgages.

Yet another key question is the amount of closing costs that home buyers should be expected to pay in cash before purchasing a home. FHA traditionally has allowed borrowers to finance their entire closing cost. That was a very important benefit, because closing costs can be quite expensive, especially in communities strapped for additional revenues to fund roads or schools or other social services. Most analysts consider the cash required at closing to be far and away the most difficult barrier to homeownership.

Other important questions relate to how recent management improvements and how reforms implemented in the HUD Reform Act are affecting FHA's long-term financial strength. This morning's hearing gives us an opportunity to explore additional management reforms that may be needed to safeguard the FHA program.

I look forward to this hearing. We have an outstanding group of witnesses to explore this important subject. The Subcommittee will include your written testimony in the hearing record. This morning's hearing will be conducted as a roundtable discussion. Participants in earlier roundtables have found that this format permits a more open and useful discussion of ideas among witnesses and Subcommittee members.

I encourage everyone at the table to be forthright in your comments. It's especially important that you speak up if you have differences of opinion with anything that is said here by someone else. That's the best way for the Committee to explore the issues before us this morning.

I also urge you to be brief in your comments so that everyone will have a complete opportunity to participate. We have a lot of ground to cover in a short period of time. I'll try to move the discussion along to include all the issues on the discussion guide that is before you.

The administration has asked that Assistant Secretary, John Weicher, be permitted to begin the hearing with a 5-minute opening statement. We're happy to accommodate this request. That may be a good way to draw comments from each of our other witnesses.

Before we proceed to Mr. Weicher, other Senators may wish to make opening remarks, and I ask my partner in this enterprise, Al D'Amato, to make whatever statement he chooses.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Thank you, Mr. Chairman. I would imagine, as you indicated, that you want people to respond to those state-

ments that are made. Many responses will be made to my statement.

Because, Mr. Chairman, notwithstanding the discussions we had with respect to FHA and where we find the fund and the need for reform on the Senate floor, I mentioned last week that the Price Waterhouse report, in my opinion, may have been too optimistic. Mr. Chairman, I'm convinced more than ever that it absolutely could not stand the test of actuarial soundness, the FHA fund, today.

Absolutely that report was overly optimistic and made assumptions that there would be growth of 2 to 4 percent in the real estate market as it related to single-family homes. Now if anybody here is going to call themselves an expert as it relates to real estate and the values of homes, I defy you to tell me where and how you can make a presumption that we're going to have prices in America growing at 2 to 4 percent.

Anybody here want to say that that's what's taking place with homeownership in America? We can go by region through region through region, and we see nothing but a total collapse, whether it be in the southwest, whether it be in Texas, whether it be in New England, whether it be in the northeast, whether it be in Long Island where I live, whether it be right here in Washington, DC.

I've got all these nice remarks that my staff put down here, and they didn't put them down with this—well, with this kind of emotion. They have me going through this little presentation about how we have to read The Washington Post last Friday and how it says that for the first time in 10 years that the market here is going through and experiencing some troubles.

Are any brokers here in this area that think that the market's going to get stronger in the next 6 months? In the next year? What kind of economic forecast can you make to predict that? Job opportunities going to increase in this region? This is the one region, the one bastion in the whole country, right here, Washington area—never had to worry about prices going down. Try to sell a condominium today in the city of Washington.

Now, look, I've been friends with the realtors, worked with them; with the home builders, worked with them. I'm not the enemy. But we're deluding ourselves when you're coming in here—put that ridiculous thing up! Put that thing down so they can see the whole thing.

[Chart I.]

SLAMMING THE DOOR ON THE AMERICAN DREAM

CHART I

Housing Bill Could Shut Out 100,000 Home Buyers

FHA, currently a mortgage insurer to more than 700,000 home buyers per year, now faces proposed changes to its single family mortgage insurance program that would:

—Require two-thirds of closing costs be paid up front; increasing the out-of-pocket costs on a typical FHA loan by $1,400;

—Institute a new form of "risk-based" premiums, which would increase the cost of FHA insurance from the current level of 3.8% of loan value to 7.6% for those with less than a 5% down payment.

WHAT'S AT STAKE?

The proposed changes, part of The National Affordable Housing Act, would shut out as many as 100,000 home buyers a year who could now use the FHA's single-family mortgage insurance program. **Ironically, this bill purports to help ease housing affordability problems!**

Although Congress and the Administration have consistently reaffirmed an interest in supporting the "American dream" of owning a home—the FHA reforms in this bill hit hardest at the entry-level home buyer, who is facing an increasingly difficult struggle to meet the up front cash requirements of home ownership.

OUR VIEW

Since 1934, the FHA's single family mortgage insurance fund has been self sustaining. We want to keep it that way. However, the measures being proposed far exceed what is necessary to preserve FHA's financial health.

There is a better way. The National Association of Realtors supports changes to the FHA single family mortgage insurance program that will keep the program fiscally sound without cutting it off to lower-income borrowers.

NAR supports the collection of a lower up-front mortgage insurance premium, which the borrower could finance, along with an annual renewal fee. This would raise the funds needed to keep a sound FHA mortgage insurance fund, while having a minimal impact on borrowers' closing costs and monthly housing payments.

Affordable homeownership has been a national priority for 50 years... We want to keep it that way! That's why the National Association of Realtors is calling the U.S. House of Representatives to reject the changes in FHA recently passed by the Senate.

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The Voice for Real Estate™

NATIONAL ASSOCIATION OF REALTORS
777 14th St. N.W., Washington, DC 20005 (202) 383-1233

Look at this! Closing the door, slamming the door on the American dream. That is absolute nonsense! And I say that to my friends with all due respect, but if you can publish that kind of trash—and I can tell you what I think it is—and that's what it is. It's inflammatory. It's wrong. It's downright rotten. It's deceitful.

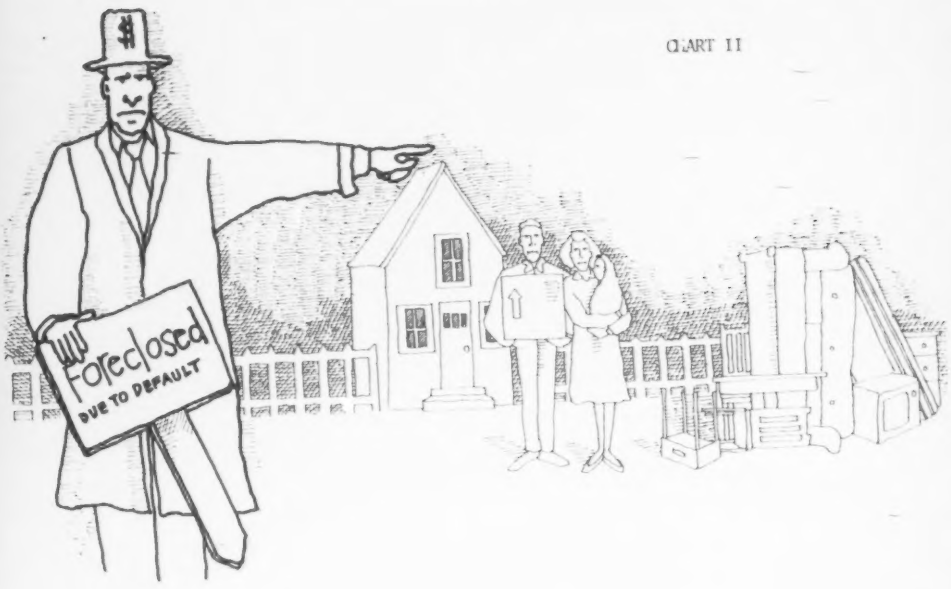
I'm going to tell you something. I'll tell you what you're doing. You want to pimp for a bunch of mortgage brokers who really don't care, who grind them out, who are the mills, who don't want to see and don't care about what happens to people a year from after they come in because they don't have enough equity and because prices are going down. And they don't give two hoots and a holler about those families—and, by the way, that's not most of our mortgage brokers.

I don't really think that most people want that to happen, but the 1 or 2 or 3 percent of them who were just grinding out, just churning 'em out, so that they could make their $400 or $500, and they don't give a darn after that person leaves, I'll tell you what you leave America with if you don't do something. You will really slam the door on homeownership. And this is what you'll do.

Go ahead. Put it up there.

[Chart II.]

CHART II



That's more accurate. There's old taxpayer picking up the bill. That's what you're going to have. Now, predicated on facts, you had 1 out of 5 of the people who don't put up any money to speak of, who put the minimum downpayment, are being foreclosed. And that's when the market was pretty good! That's when the market was going up! That's when you had prices increasing!

Now, in the face of a collapsing market, you want to continue the same old tired trends? I mean, come on, be fair. Wake up! What are we doing? Do you really want to do that? Do you really want to continue the same old political mumbo-jumbo, and then when the American taxpayer comes, what are you going to say then? Who do we blame it on?

Now, look, then I'm going to have to worry, "The realtors supported me, so I have to send back any money that the realtors ever gave." Huh? Mortgage brokers supported me, so then we'll have to all—it will all be tainted money. Come on, fellahs—and ladies. I mean, you don't really believe that, do you?

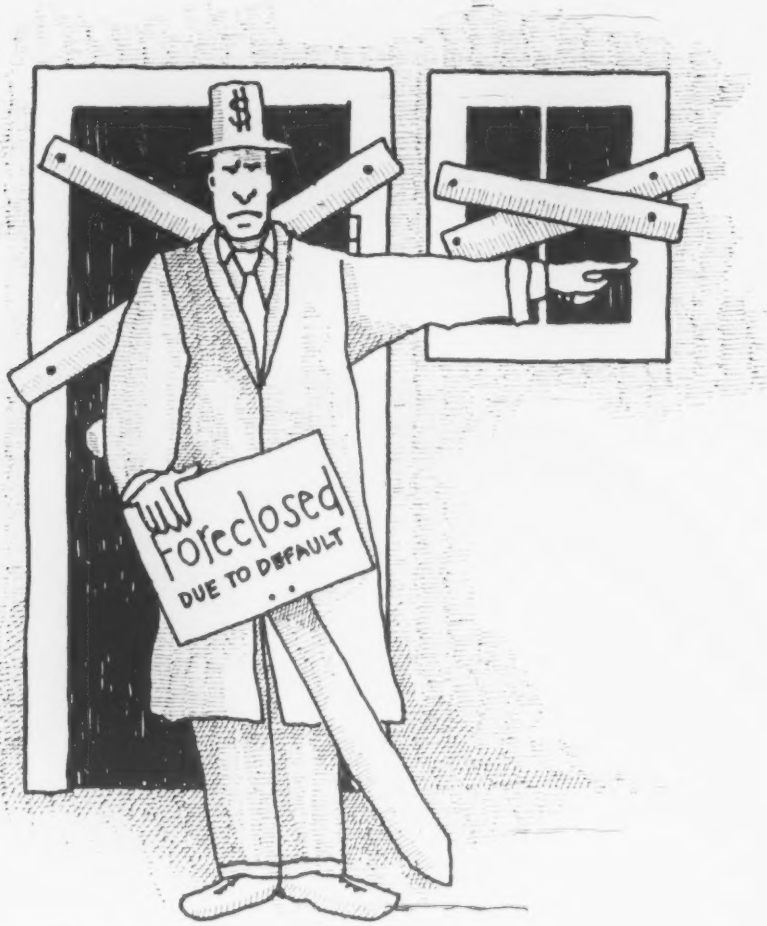
You really believe we should continue the practice and the fund is actuarially sound. And I want to tell you, I'm going to be very interested to hear what our representatives from HUD say in light of the changing economic situation. I'll bet you—I haven't read their report—I bet you they're going to hedge it a little. You better hedge it, and say, "Well, you know, that report was put together 2, 3 months ago, and in the meantime, you see a deteriorated market."

The market is going down. It's not going up. And there's no hope for it to go up in the immediate future with the RTC selling off and selling off.

Now I'm going to show you what you're doing. You want a more accurate—if we continue the same policy—and, by the way, statistics, you know, can be manipulated. All right, and we'll talk about that. Here's what you're going to be doing.

[Chart III.]

CHART III



This is the picture of what you give to America. Here, why don't you put that in there: the foreclosure, the heartache that takes place to a family that, because the mortgage broker didn't care, because they didn't get the right counseling, because they didn't have a downpayment, because they didn't have discipline in terms of learning how to save, that figure, instead of being 1 out of 5 being foreclosed who come in at the—not, by the way, at the lower economic area, but the lower amount of money put into a project. That's what you're going to be doing.

I think that that's a travesty and it's wrong. And I'm going to tell you something. The reforms that we proposed in the Senate do not go far enough and I will not support them. They do not go far enough. I am convinced that since we passed that bill, which is only several weeks ago, that if you can't see that the situation has deteriorated, that it's gotten worse, then shame on us. Shame on all of us! It's absolutely scandalous!

And you've got an opportunity here—and I don't know; I don't believe the FHA fund can be made sounder, even as it relates to some of the modest changes that we have made. I don't believe it can. Because, don't forget, what we had was a situation where Price Waterhouse presumed there would be a growth of 2 to 4 percent as it relates to value and properties. We asked them, "If that's not attainable, what do you say?" And they said then obviously that would change the basis of our conclusion.

My friends, there's nobody here who can reasonably predict that this 2 to 4 percent growth is going to continue. Now I say this to people who have been supportive, who I've been supportive of, because I believe in the principles of homeownership. And for you to suggest that because we're asking for modest reform—modest!—modest reform to try to cushion the blow that the taxpayers are going to pick up and to keep the program from being shut down, if you want it to be shut down, just close your eyes.

And there will be multibillion dollar losses. And you're going to have a loss. And I say to you now that if you came in and took a snapshot now and made a prediction and got people to predict what the economic situation will be as it relates to real property values, that the fund is in a deficit position.

But, if you want to continue to put blinders and just say nice things and say that if you're going to suggest reform that you're closing—by the way, 3 percent down on the mortgage of $50,000 and that's too much? And then we say you should pick up two-thirds of the closing costs? And you suggest that's onerous? You know, how much do you think the taxpayers are going to be able to take?

So I just suggest for the industry, for ourselves, I would hope that you would reappraise your position. Do I think you're going to do it? No, I don't. And I think sometimes you've got to go back and tell the people that you work for, "Hey, fellahs, you're barking up the wrong tree."

And I'm going to tell you something: most realtors aren't engaged in the kinds of things that I've said, and most mortgage brokers aren't. So who are we shilling for? By taking these preposterous positions of saying that the legislation that we've put up is going to deprive people of homeownership and just totally forget

that you have one out of five of these places that are going to be coming up on the market for those people who come in with inadequate downpayments, I mean, who are you protecting?

You're not doing your associations good. You're not doing the realtors any good. We're not doing the system any good. I'd suggest that we're just making it more tragic and we're compounding it.

So, Mr. Chairman, I'm going to ask that the balance of my statement be placed in the record as if read in its entirety, and I thank you for giving us the opportunity of having this, because I'm going to be interested in asking some of our people how they can subscribe to doing business as usual in the face of what we now have today, which is a deteriorating real estate market.

I thank you Mr. Chairman.

[The complete prepared statement of Senator D'Amato follows:]

PREPARED STATEMENT OF SENATOR ALFONSE D'AMATO

When we were discussing FHA reform on the Senate floor the other week, I mentioned that Price Waterhouse may be too optimistic about home price appreciation. If this is true, then the FHA insurance fund is in even more trouble than we think.

As you may recall, the Price Waterhouse report on FHA assumes an appreciation rate of about 3¼ percent. On the Senate floor, I stated my concern about this figure. It seems awfully optimistic to me.

Yesterday's Washington Post confirms my nervousness.

On the front page of yesterday's Post, we find out that the Washington housing market is falling. For the first time in 10 years, the median home price for the Washington metropolitan area actually dropped. It's not that it didn't grow, it actually fell.

Mr. Chairman, I'd like to request that this article be made part of the record. The article shows that prices fell 5 percent between April 1989 and April 1990.

Although Washington is only one part of the country, the drop in home prices is counter to information that analysts have been telling us for years.

Many analysts said that the Washington real estate market would remain strong because of the area's stability, strong employment diversity, and good yuppie base. "Don't worry," they said, "prices will keep rising here." Well, they were wrong. And Price Waterhouse may be wrong, too.

Even as we speak, people are driving around the area with a bumper sticker on their car that says "Now really is a good time to buy a new home." Well, Mr. President, maybe now is a good time to buy a home. If you can raise the downpayment, if you need a house, if you have a family, of course I'm for homeownership. But if you're trying to ride some speculative real estate wave, if you're putting the minimum downpayment down, if you're hoping that appreciation will make you money, then you might as well be playing the lottery, because the real estate market isn't that good.

This trend is probably similar to many other parts of the country. Even the National Association of Realtors recognizes this. The Realtor News reports that the median price of an existing home—for the entire Nation—dropped in April, and dropped more in May. Since January, the median price has dropped 1.6 percent. So much for assuming 3.25 percent appreciation into the indefinite future.

Mr. Chairman, I ask that this article be inserted for the record.

History also tells us to be cautious. During the late 1970's and early 1980's home price appreciation was so fast that almost anybody who got into the market made money. Areas like Texas, the Southwest, New England, and Washington were boom markets where everybody made a killing. But the market in Texas fell. The market in the Southwest fell. The market in New England fell and is still falling.

The Price Waterhouse report looked at what would happen if home price appreciation is lower than 3.25 percent. The report shows that if home price appreciation is 1.25 percent instead of 3.25 percent, then the economic value of the fund would be reduced by $1.6 billion. Consequently, the value of the fund would be $1 billion instead of $2.6 billion, as computed under the 3.25 percent assumption.

This is a very small margin for an insurance fund that has to cover more than $250 billion of insurance in force. We must take prompt and effective action to protect the soundness of the FHA insurance fund.

Washington Post 7/2

Median Home Price Falls; First Drop in 10 Years

By Kirstin Downey
Washington Post Staff Writer

The median price of single-family homes in the Washington area fell 5 percent between April 1989 and April 1990, in what appears to be the first decline in local housing prices in at least a decade.

The median price of single-family homes in the Washington area dropped to $191,985 from $202,239, after rising steadily for almost 10 years, according to real estate transaction records compiled by the Silver Spring-based real estate information company of Rufus S. Lusk & Son Inc. The study compared April 1989 new-home and existing-home sales prices with those from April 1990.

Some longtime real estate brokers said their experience confirms the figures and reported evidence of across-the-board price declines. They said some homes are selling for less than their appraised values and others are selling for less than their assessed values. They also reported they are seeing cases in which properties are selling for substantially less than similar, or even identical, properties sold for two years ago.

"For the first time in my career, and this is my 30th year in real estate, I have seen the average price of a house sold for less than it was the year before," said William Ellis, executive vice president of the residential division of the Shannon & Luchs real estate firm.

"The sales that are going through are definitely for less than what similar houses sold for a year ago, or even six months ago," said real estate broker Gail Belt of Town & Country Properties Inc.

Belt said a colonial-style home she sold in Vienna last summer for $389,000 is on the market again now with an asking price of $369,000.

"This is a deeper cut, and an all-pervasive cut, there's no doubt about it," Belt said. "I don't see any rapid bouncing back."

Rufus S. Lusk III, president of the company that conducted the study, characterized the decline as evidence of a healthy readjustment of a market that had become unbalanced and overly expensive.

He said home prices had risen so quickly in the Washington area in recent years that they had simply outstripped people's incomes in many cases.

Over the past year, real estate industry officials had noted that prices had flattened in the face of a

See HOME PRICES, A8, Col. 2

HOME PRICES, From A1

growing inventory of unsold homes, but the April statistics provided by Lusk suggest that the glut has finally translated into declines in prices. In addition, however, the market mix has shifted from an emphasis on expensive trade-up housing to more affordable homes, which also tends to depress the median price.

Lusk said the new numbers indicated that April 1989 was what he called the "high-water mark" of the Washington real estate market. He said early indications are that similar declines will be seen when the May and June transactions are compiled.

Local home sellers are exacerbating the situation, Lusk and local brokers said, because of their unwillingness to drop prices from the levels they had hoped to obtain. Many have flatly refused to cut their prices, leaving their homes on the market for months, and that has added to the growing oversupply of unsold homes. Now, however, with the peak summer selling season well underway, many sellers can no longer hold out, they said, and are finally reducing their prices to sell. "Everybody wants to buy low and sell high," Ellis said. "But we're not in a position where you can sell high anymore."

The Lusk study found notable regional variations in the April-to-April comparison. The decline was most extreme in the District of Columbia, where the median single-family home price fell 9 percent, to $183,451 from $201,192. In Fairfax County, it fell 6 percent, to $215,934 from $230,636, and in Montgomery Country, it dropped 3 percent, to $216,446 from $224,242. Alexandria prices fell 3 percent, to $203,960 from $210,100.

In general, the less costly areas and housing types are selling best. Property values in Prince George's County, for example, have maintained a steady increase since the beginning of the year. The median price there climbed 11 percent between April 1989 and April 1990, rising to $129,192 from $116,059. Arlington County prices increased 2 percent, to $224,983 from $220,400.

The condominium market has maintained a generally stable course, with prices in some jurisdictions rising and others falling. Overall, throughout the region, condominium prices fell about 1 percent, to $105,055 from a median price of $106,006.

The Lusk study tracked median prices, the midpoint figure at which half the homes sold for more and half for less. That number is considered more statistically significant than the average price, which can be easily skewed by a relatively few transactions, such as the sales of multimillion-dollar estates.

12

WASHINGTON-AREA RESIDENTIAL SALES AND MEDIAN PRICES

AREA	SINGLE-FAMILY HOUSES NO. OF SALES	SINGLE-FAMILY HOUSES MEDIAN PRICE	CONDOMINIUMS NO. OF SALES	CONDOMINIUMS MEDIAN PRICE
ALEXANDRIA				
April 1989	107	$210,100	137	$101,863
April 1990	108	203,960	189	117,071
Increase (decrease)	1	(6,140)	52	15,208
Percent change	1%	-3%	38%	15%
January-April 1989	344	203,486	480	98,625
January-April 1990	331	204,900	634	102,634
Increase (decrease)	(13)	1,414	154	4,009
Percent change	-4%	1%	32%	4%
ARLINGTON COUNTY				
April 1989	153	220,400	175	121,860
April 1990	138	224,983	166	121,903
Increase (decrease)	(15)	4,583	(9)	43
Percent change	-10%	2%	-5%	0%
January-April 1989	520	208,500	604	116,242
January-April 1990	479	208,419	618	132,744
Increase (decrease)	(41)	(81)	14	16,502
Percent change	-8%	0%	2%	14%
DISTRICT OF COLUMBIA				
April 1989	430	201,192	205	105,592
April 1990	336	183,451	203	105,089
Increase (decrease)	(94)	(17,741)	(2)	(503)
Percent change	-22%	-9%	-1%	0%
January-April 1989	1,672	181,452	784	96,260
January-April 1990	1,267	186,972	738	97,497
Increase (decrease)	(405)	5,520	(46)	1,237
Percent change	-24%	3%	-6%	1%
FAIRFAX COUNTY				
April 1989	1,810	230,636	566	114,397
April 1990	1,396	215,934	440	109,079
Increase (decrease)	(414)	(14,702)	(126)	(5,318)
Percent change	-23%	-6%	-22%	-5%
January-April 1989	6,238	219,251	1,878	112,756
January-April 1990	4,912	221,568	1,525	127,256
Increase (decrease)	(1,326)	2,317	353	14,500
Percent change	-21%	1%	-19%	13%
MONTGOMERY COUNTY				
April 1989	1,186	224,242	327	101,463
April 1990	945	216,446	303	101,315
Increase (decrease)	(241)	(7,796)	(24)	(148)
Percent change	-20%	-3%	-7%	0%
January-April 1989	3,989	210,697	1,223	94,679
January-April 190	3,628	215,620	1,062	105,833
Increase (decrease)	(361)	4,923	(161)	11,154
Percent change	-9%	2%	-13%	1[illegible]%
PRINCE GEORGE'S COUNTY				
April 1989	936	116,059	183	76,572
April 1990	948	129,192	203	76,916
Increase (decrease)	12	13,133	20	344
Percent change	1%	11%	11%	0%
January-April 1989	3,343	113,026	721	69,984
January-April 1990	3,426	125,614	716	68,801
Increase (decrease)	83	12,588	(5)	(1,183)
Percent change	2%	11%	-1%	-2%
TOTAL				
April 1989	4,622	202,239	1,593	106,006
April 1990	3,871	191,985	1,504	105,055
Increase (decrease)	(751)	(10,254)	(89)	(951)
Percent change	-16%	-5%	-6%	-1%
January-April 1989	16,106	190,476	5,690	100,356
January-April 1990	14,043	192,659	5,293	108,592
Increase (decrease)	(2,063)	2,183	(397)	8,237
Percent change	-13%	1%	-7%	8%

SOURCE: Rufus S. Lusk & Son Inc.

Falling interest rates help to stabilize home resales rate

The sales pace of existing single-family homes in May was up 1.2 percent from the pace recorded during May 1989, according to NAR's latest survey of local boards of REALTORS® across the country.

Existing single-family homes were sold at a seasonally adjusted annual rate of 3.29 million units in May, compared to the 3.25 million-unit pace one year earlier.

May's national home resales rate was 1.2 percent below April's rate of 3.33 million units.

NAR economists credited falling interest rates with slowing the month-to-month decline in the home resales pace.

Nationwide, the average commitment rate on 30-year, fixed-rate conventional mortgages fell from 10.67 percent in April to 10.33 percent in May. In general, mortgage interest rates were lower in May than in May 1989.

Mortgage rates are not expected to rise during the summer, NAR economists say.

NAR President Norman D. Flynn is urging potential buyers to make their home purchases now.

"It's time for people to quit straddling the fence," Flynn says. "Conditions are ripe for buying. The home supply is up, and mortgage rates are down."

Lower interest rates did entice some home shoppers—especially entry-level buyers—back into the market in May, Flynn said, resulting in an $800 month-to-month decline in the median resale-home price to $94,800 in May.

May's national median resale-home price was up $2,200—2.4 percent—from one year earlier.

In the Northeast, May's resales pace of 520,000 units reflected a 13.3 percent decline from the 600,000-unit pace recorded one year earlier but was unchanged from the previous month.

The median single-family home price in the Northeast stood at $141,300 in May, a 1.7 percent decline from the $143,800 median price one year earlier.

The region's lower median price indicates that a greater volume of homes are being purchased in a lower price range, NAR economists say.

"Overall, the Northeast market appears to be stabilizing," notes NAR Chief Economist John A. Tuccillo.

The largest month-to-month sales pace increase was recorded in the West, where the May resale rate of 590,000 units rose 1.7 percent from April and remained unchanged from May 1989.

The median home price in the West was $135,300, a decline of 4.8 percent from May 1989, when the median price was $142,100.

The lower median price there indicates that appreciation has slowed in high cost areas, according to Tuccillo.

"No market can withstand price surges indefinitely," he says. "As more buyers become priced out, demand slacks off, and prices revert to a more sustainable level."

In the South, May's home resales rate of 1.31 million units was up 7.4 percent from the May 1989 rate of 1.22 million units.

The South's median resale home price in May was $85,200, a gain of 1.2 percent from the $84,200 median one year earlier.

The Midwest recorded a resales-rate gain of 4.8 percent from May 1989's pace of 840,000 units to this May's pace of 880,000 units.

The median existing home price in the Midwest was $73,100 in May, up 4.0 percent from May 1989, when it was $70,309.

NAR predicts home resales will total approximately 3.46 million units for 1990, rising 0.5 percent from last year.

HOME SALES

MEDIAN SALES PRICE OF EXISTING SINGLE FAMILY HOMES

1989	May	$92,600
	Jun	93,500
	Jul	95,200
	Aug	95,800
	Sep	93,800
	Oct	92,400
	Nov	93,100
	Dec	92,500
1990	Jan	96,300
	Feb	95,200
	Mar	96,300
	Apr [r]	95,600
	May [p]	94,800

SOURCE: NATIONAL ASSOCIATION OF REALTORS®
[r] Revised [p] Preliminary

Senator CRANSTON. Thank you, Al.

Senator Riegle, Chairman of the Banking Committee could not attend this morning because he has conflict with the full committee hearing on the CFTC jurisdictional issue. He asked that his statement be included in the record and it will be.

[The statement of Senator Donald W. Riegle, Jr., follows:]

STATEMENT OF SENATOR DONALD W. RIEGLE, JR.

I would like to commend Senator Cranston and the Housing Subcommittee for conducting this hearing on the safety and soundness of the FHA program. This morning's hearing will focus upon the FHA provisions incorporated in the National Affordable Housing Act just prior to the bill's passage on the Senate floor. The FHA provisions which were incorporated came about as a result of negotiations with the administration. Unfortunately, these provisions did not have the benefit of a public hearing.

Today, our distinguished panel will help us further examine the FHA provisions incorporated in the National Affordable Housing Act as we prepare for conference. We must remain mindful that an effective FHA program must assure the actuarial soundness of the FHA mutual mortgage insurance [MMI] fund while maintaining the benefits of the FHA program for the low- and moderate-income home buyer.

The single family mutual mortgage insurance fund of FHA must be made actuarially sound. Yet, we find the FHA program on a course, established during the previous administration, which will lead to its demise. The provisions which will be incorporated in a housing bill this year must preserve the viability of the FHA program and protect the American taxpayers.

During the 1980's the FHA fund began to decline. In 1980, the FHA fund had the equivalent of $8 billion in cash reserves, by 1989 the fund had the equivalent of only $2.6 billion in reserves. The abandonment of responsible management and oversight which plagued Federal housing programs during the 1980's caused the decline of FHA.

We now must rectify the past policies and procedures which have damaged the stability of the FHA fund. We can no longer allow FHA to continue a policy of unsound practices.

The final FHA provisions must ensure the safety and soundness of the FHA mortgage mutual insurance fund while preserving the FHA program's historic mission of helping those American families who need help purchasing a home.

The seriousness of the FHA problem requires that we address this issue now. While I agreed to the FHA provisions which were incorporated in the bill immediately before floor passage, this is a subject which requires ongoing analysis. If better solutions are found as we move toward conference and final passage I plan to pursue them.

Senator CRANSTON. We have a roll call that started, so please do your statement in 5 minutes, and then we will recess briefly and have time to think about it and come back and get back to work.

Before we begin I have a statement from Senator Graham.

[The statement of Senator Bob Graham follows:]

OPENING STATEMENT OF SENATOR GRAHAM

Thank you Mr. Chairman. I think it is safe to say that everyone here today agrees on importance of the public policy goals pursued by the Federal Housing Administration. FHA has been the principal means by which the Federal Government has assisted families in achieving their dream of homeownership.

Mr. Chairman, last month we heard some startling news in testimony from Secretary Kemp, Price Waterhouse, and the General Accounting Office. The MMI Fund, we were told, was not actuarially sound. Each witness told us that strong measures needed to be taken in order to restore the Fund to sound financial footing. Price Waterhouse recommended four options from which the Administration chose one.

During Senate floor debate on S. 566, it became clear that, while there was wide agreement on the need to protect the Fund and preserve its mission, there was disagreement over the best means to achieve these ends. Three different proposals were offered. After much debate, the Senate reached a compromise that built upon the Administration's original proposal. The House is now considering a different approach.

Prior to this hearing today, Mr. Chairman, we have not had the opportunity to fully analyze each of these proposals or to hear from the groups that will be most affected by our decision. I commend you for putting this forum together and look forward to hearing the testimony of these distinguished witnesses.

STATEMENT OF JOHN C. WEICHER, ASSISTANT SECRETARY FOR POLICY, DEVELOPMENT AND RESEARCH, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. WEICHER. Thank you very much, Mr. Chairman. It is a pleasure for me to appear before this committee to discuss the financial status of the mutual mortgage insurance fund and the administration proposal's for strengthening FHA so it can continue to serve first-time home buyers in the 1990's.

On behalf of the Secretary, we want to congratulate you, Mr. Chairman and you, Senator D'Amato, for your leadership on FHA and your efforts last month to forge the responsible bipartisan compromise to restore the fund's actuarial soundness and financial health.

Now our proposals and the action in the Senate came in response to the analysis of the MMI fund by the accounting firm of Price Waterhouse. We have discussed their statement in the past and they have testified briefly. They concluded that the MMI fund was solvent, but not sound, that it had a net worth of 5 percent at the beginning of the decade of the 1980's and a net worth of 1 percent at the end of the 1980's and, furthermore, that all the trends were in the wrong direction.

FHA is losing at the rate of $350 million a year on each year's business that it is now doing. At that rate, it will be bankrupt by the end of this decade and we do not want that to happen. We know that it is absolutely necessary to restructure FHA's insurance system. We do have the recent S&L experience where an undercapitalized federal insurance program continued operating on an unsound basis over a period of many years before ultimately the fund was unable to proceed and something important had to be done.

The administration proposed a number of program changes—and I won't go into them here; we have discussed them before—but simply to say that the reforms were based on four principles. Fundamentally, adequate capital levels must be achieved and maintained. Insurance premiums should be related to the risk of the insurance with higher premiums for the loans with the lower down payments, because we know that the loans with the lower down payments are the ones on which we lose the most money. People who buy homes should have a real equity interest in their homes. And, finally, FHA should continue to focus on meeting the mortgage credit needs for low- and moderate-income home buyers.

The proposal that was adopted in the Senate, the proposal that you, Mr. Chairman, and you, Senator D'Amato, worked with us to develop does uphold these four principles. Your actions have helped to develop a consensus as to what's needed to restore FHA to soundness and help to unify the effort to adopt a plan as a part of the comprehensive banking legislation.

Importantly, as part of that, the Senate adopted the recommendation of Price Waterhouse that FHA should raise its capital to 1¼

percent of insurance in force from the present 1 percent as soon as possible. Price Waterhouse referred to that as a minimum standard, not a desirable standard. We regard 2 percent as the minimum goal that should be achieved in the 1990's, and the Senate agreed with us on that.

Most of my statement concerns some of the discussion of the administration proposals over the last months by industry groups and others in the housing field, particularly some misconceptions, some misstatements about the proposals that have been made, and I really wanted to clarify them. Very briefly, it has been said that Price Waterhouse study is based only on the 1980's, which were a very bad decade for housing, and so the Price Waterhouse study is overly pessimistic, the opposite of the concern that Senator D'Amato raised. In fact——

Senator CRANSTON. Who says that?

Mr. WEICHER. We have heard this. We heard this from several witnesses in the hearings in the House, Mr. Chairman, which several representatives of the industry and other people discussed.

In fact, the analysis is based on the years from 1975 through 1989, the 5 very good years of the late 1970's when, while inflation was ravaging the economy, it was nonetheless very good for the housing market for people's equity in their homes. Then, the first half of the 1980's, which were not a good period. And then, the last half of the 1980's when, even though the economy is strong, FHA is losing money.

Second, it's been suggested that our proposals and the study ignore the economic recovery of the southwest, which will reduce FHA claims in the 1990's. In fact, that's not correct. The analysis is based on regional house price variation for the country as a whole over the next decade that's similar to experience in the past decade. It means that we expect regions which have been lower than average to improve, and some regions which have been above average will not improve. That is, we'll have a deterioration in house prices.

We have seen some of that softening in some markets where, as in the northeast, where house prices did very well for a long time and now they've been softening and meanwhile they are firming up in southwest. At the same time, we are still paying claims in the southwest, and that's where a substantial share of our defaults are.

It's been said that the report failed to take into account the management reforms recently instituted at FHA and, therefore, overestimates FHA losses. The only management reform which can be counted under reasonable accounting and, I think, reasonable policy practices, is the termination of investor loans. And Price-Waterhouse did, in fact, for future business assume that there will be no investor loans.

In other respects, we expect to be able to save money for FHA in the future by management reforms which the Secretary has stated, but we cannot bank on those.

Senator CRANSTON. If you'll excuse us, we have to go, but we will be back in 6 or 7 minutes.

Mr. WEICHER. Fine. Thank you.

Senator CRANSTON. We will stand in recess briefly.

[Recess.]

Senator CRANSTON. The hearing will reconvene. I want the record to reflect that Senator Pressler cannot be here today. He was planning to participate as he usually does, but his father passed away last weekend. He is in South Dakota for the funeral. We extend our sympathies to the Senator and to his family.

We now return to you, Mr. Weicher, to complete your statement. I wish you would comment on one aspect of what Senator D'Amato said, and that was his view that the Price Waterhouse study is over-optimistic because of, as he put it, an assumption that there would be a 2 to 4 percent increase in home costs generally and his view that now we seem to be in a declining situation.

Mr. WEICHER. Thank you, Senator Cranston. I'll be happy to comment on that very briefly. As you know, the Price Waterhouse study covers the period through the end of fiscal year 1989. We do have some information on changes in house prices from the Census Bureau nationally for the first 6 months of fiscal year 1990.

And through the first 6 months, it is true that prices are appreciating more slowly than were assumed in the Price Waterhouse analysis.

Senator CRANSTON. Are they still appreciating nationwide?

Mr. WEICHER. They are appreciating, but the Price Waterhouse analysis is based on the range of appreciation that Senator D'Amato cited. And they are appreciating below that range. And we do know that if prices on average appreciate at 1 to 2 percent, there will be a larger number of houses where prices will decline. This is an average, and we know that there will be dispersion around the average.

And the lower the average increase is, the more houses there will be that will actually decline in value and also the more houses there will be on which we will experience defaults. And private mortgage insurers will experience defaults and conventional lenders will experience defaults.

Now that is only 6 months, and the time horizon for the analysis is much longer, but those 6 months are a small step in the wrong direction. And, to that extent, so far the analysis may turn out to be slightly optimistic. Now we are not in a position to do the analysis every quarter or every other quarter, but that is one significant bit of information that we have since then.

If I may resume just briefly to finish up the points I wanted to make in response to some of the comments that have been made about the report, the fourth point I wanted to make was that it's sometimes said that the administration's proposal to require homeowners to pay two-thirds of their closing costs in cash will result in the less risky borrowers leaving FHA in favor of conventional loans with private mortgage insurers.

This is, I think, a very basic misunderstanding. The less risky borrowers, the one who make downpayments of 10 percent or more and the moderately risky borrowers who make downpayments of 7 percent or more, they will basically be able to pay the two-thirds of their closing costs in cash quite easily. They are now putting down significantly more than the minimum downpayment. If they don't want to add two-thirds of their closing costs to that, they can

simply designate 2 percent of their downpayment to represent the closing costs.

The rest of the down payment that they are making, the rest of the up-front payment that they are making, is the downpayment, and there is no reason for them to change their behavior in any way. The less risky borrowers, those with 7 percent equity, 7 percent downpayment or above, should not be affected by our proposal in this way at all.

It's also worth remembering here that we are, to my knowledge, about the only entity in the lending field who allow financing of closing costs. Others require that closing costs be paid in cash. Our policy here is contributing to our defaults.

Fifth, I have seen some statements that the low downpayments permitted under the current FHA program are not the principal cause of FHA's default problems. Mr. Chairman, that's clearly incorrect. Price Waterhouse's study confirms what just about every study that I know of has shown in the past of FHA and other kinds of lending: the lower the downpayment, the greater the risk of default.

I attached a figure to my testimony, figure 1, which shows our claim rates by the loan-to-value ratio, and you will see that as we get above a 95 percent loan-to-value ratio, as the downpayment is less than 5 percent, our claim rate approaches—our default rate—our claim rate approaches 20 percent, which is just extraordinary. Whereas, as we get to a downpayment of 10 percent or more, loan to value of 90 percent or less, our claim rate is down under 10 percent in the range of 6 or 7 percent.

Senator D'AMATO. What does that suggest to you, Mr. Weicher, if I might.

Mr. WEICHER. It suggests to us that people who do not have any real equity in their home are likely to default and that we will take losses on those homes. And this is one of the reasons for our policy recommendations.

Senator D'AMATO. Can I ask you something on that point? When you made the study in which the 1 out of 5 who had less than 5 percent in their homes defaulted, that covered the period of time from 1975 through 1989?

Mr. WEICHER. That's right. It's based on that.

Senator D'AMATO. And in that study, was there an opportunity to demonstrate or have we concluded what the appreciation or value in homeownership was on an annualized basis?

Mr. WEICHER. Let me start by responding a little more fully to the first part of your question. The figure 1 is a 20 percent default rate that we anticipate on these loans in the future based on experience that we had in the past and based on the assumption of the 2 to 4 percent price appreciation which you questioned earlier.

Senator D'AMATO. You do have a default ratio of 1 out of 5 for those people in the past.

Mr. WEICHER. No, for the people in the 1970's, that is much lower. For the people in the 1980's, it is much higher.

Senator D'AMATO. For the people in the 1980's, it is much higher?

Mr. WEICHER. Yes.

Senator D'AMATO. 19.34 percent default ratio?

Mr. WEICHER. Yes.

Senator D'AMATO. So it is 1 out of 5?

Mr. WEICHER. Yes, but——

Senator D'AMATO. Maybe Price Waterhouse has the answer. What was—as it relates to the appreciation of properties, if you do have that, what was the average annualized appreciation for the period that the study covered or upon which you have made your analysis? If it is 1975 through 1989 or any other period, I would really appreciate knowing that. Was it 3 percent, 4 percent, 5 percent annually? What was it?

Mr. WEICHER. I think we're all trying to check the study at this point to see if we have the actual numbers.

Senator D'AMATO. I'm wondering about if our friends in the real estate area could give us suggestions.

Mr. HENDERSHOTT. You might check exhibit 212 on page 21 in the Price-Waterhouse report. It gives you for different time periods for the nation and for different regions what the appreciation rates were.

Senator D'AMATO. 76 through 1981, 12 percent; 1981 through 1989, 2.7 percent. That's national. Then you've got the Northeast, the Midwest. So you have all your national averages: 4 percent, 8.2 percent, 12 percent, 2.7 percent. Thank you very much.

Mr. CRAREN. That is correct, yes.

Senator D'AMATO. I think it is rather relevant, because if you find the fund getting itself into some difficulty, and the last rate that you have was 1981 through 1989, which takes in some of the difficult periods, but also takes in some of the tremendously inflationary periods which resulted in prices soaring in 1983 and 1984 and 1985, and they did, and I don't know if we can look forward to that, it just raises in my mind the problem that I believe that we are going to be incurring and are now incurring.

We are incurring it now, but——

Mr. WEICHER. If I may say so, Senator D'Amato, just at the beginning of the resumption of the hearing, Senator Cranston asked me if I would comment on the optimism or pessimism of the Price Waterhouse report. And I mentioned that in the first 6 months of this fiscal year, we are, in fact, seeing house price appreciation rates that are below the range in the Price Waterhouse analysis.

Senator D'AMATO. Appreciation rates.

Mr. WEICHER. They are lower in the first 6 months than in the analysis. Now that is 6 months out of a long period, but it is 6 months of a step in the wrong direction, what I would call a small but possibly significant bit of information.

And, of course, if—one of the things that is included in the Senate bill is that if the Secretary will report to you annually as to how the fund is doing so that if the analysis proves to be too optimistic or too pessimistic, we will be providing you with information and recommendations as to what corrective action might be taken, and we are firmly committed to doing that.

Ms. MEIER. Can I ask a question about the last statement on the appreciation of home values in the last 6 months? Were you looking at homes in all price categories or just in that segment of homes priced at levels that are eligible for FHA?

Mr. WEICHER. That's the Census Bureau's price index of new single-family homes sold, which is the basic index of price appreciation which is used in the Price Waterhouse analysis and used in most analyses, because it's got the broadest attempt to look at the price of the same kind of house from year to year. And that's a national average and an index across all quality ranges and all prices ranges.

And the regional averages, which are changes which are also important, are only published once a year, which is one reason why the analysis can't be repeated more often than once a year.

Ms. MEIER. I would only like to make the point that, although we have seen some softening in markets, that in a lot of cases the softening is particularly happening in higher-priced home categories.

For example, in the Washington area that we are seeing a lot of slowness in the $200,000 to $300,000 priced home, but in reference to the Post article that you referred to, Senator D'Amato, in your opening statement, it said that in the lower range, lower price range of houses, there was appreciation last year. And the forecast in many markets for that starter home, which is the home that we're talking about for FHA borrowers, for the most part is still pretty strong.

Mr. WEICHER. We can hope that that turns out to be the case and that FHA turns out to be in a little better shape. We don't believe that we can plan on that at this point. And, in response to the Chairman's question, I provided the information that we do have at this point.

One final point to make here, Mr. Chairman: the concern that risk-based premiums, which we think are important, will prove to be a problem for lower income FHA buyers. Again, this is not the case, although it will sound counterintuitive.

My second figure shows the loan-to-value ratio of FHA borrowers by household income. And you will see that lowest income families, in fact, on average, have a lower loan-to-value ratio, make a slightly higher downpayment. It's almost a straight line, Mr. Chairman, but for families with incomes below the median of about $35,000, in fact, they do make a little bit higher than average downpayment, have a little bit lower than average loan-to-value ratio, and therefore the risk-based premiums will cut about equally across all income brackets, but they will, in fact, bear a little bit more heavily on FHA buyers in the upper half of the income distribution than the lower half, very slightly, but they will not disproportionately affect the lower income buyers.

In conclusion, Mr. Chairman, I simply want to say that we at HUD consider FHA to be one of the Government's great success stories. We want to continue encouraging homeownership through the FHA program. We're certainly not happy that FHA is in serious financial difficulty. We recognize that some homeowners will have to pay more under our proposals, and we anticipate that a small number of borrowers—we estimate up to about 35,000—will not be able to buy homes as soon as they would under the present policies.

We're not happy about that either, but we have to strike a balance between encouraging homeownership and the survival of the MMI fund. Unless the reforms are made, the MMI fund will contin-

ue to lose money and the dream of homeownership for first-time home buyers and young families who are starting out will be jeopardized. We need to restore FHA to soundness, to financial strength. We need to do it now so it can continue to support homeownership in the future.

Mr. Chairman, I just want to finish by noting The Washington Post editorial this morning on the subject of FHA, and just to conclude with the last two sentences from that editorial:

> It is dangerous to lend more on a property than its market value. And it's double-dangerous to run a Government-backed insurance fund by rules under which it steadily loses money.

We want to change that, Mr. Chairman, and again we appreciate the spirit with which you in the Senate, especially you, Mr. Chairman, and you, Senator D'Amato, approach this after the Secretary's testimony and appearance before this committee on June 6. Thank you very much.

Senator CRANSTON. Thank you for being brief. I suggest that we start our discussion now by having those of you who wish to take account of Mr. Weicher's specific comments. And Mr. Flynn wants to speak also.

Come in whenever you wish, of course, but I suggest that we try to focus to the degree we can on Mr. Weicher's specific comments and then address two questions: based on your professional experience, first, how do you assess the need for Congress to take action to change FHA's premium structure along the lines suggested in the administration proposal or in alternative proposals that are under consideration in Congress. How urgent is it that we act? What would be the consequences if action was put off, say, until next year?

And, second, how do you assess these specific proposals put forward by the administration? Do you think it is the right approach or does it move in the wrong direction? If you support it, what is its major strengths? If you oppose it, what are its major weaknesses and what do you propose that we do about them?

Who wishes to start? Mr. Lasko.

WARREN LASKO, EXECUTIVE VICE PRESIDENT, MORTGAGE BANKERS ASSOCIATION, WASHINGTON, DC

Mr. LASKO. Thank you. Senator, as you know, Senator, I'm Warren Lasko. I represent the Mortgage Bankers Association and the mortgage banking industry. Mortgage bankers make about 75 percent of all FHA loans, so we obviously have a business interest. But we think that we also speak for the social purpose of the program in being here today.

Senator Cranston and, especially, Senator D'Amato, as lenders, we recognize full well that FHA cannot do business as usual in the decade ahead as it has done in the decade just past. We absolutely agree with you. We absolutely agree with you that we want a sound FHA. If 2 or 3 percent of the lenders out there are abusing the program, we abhor that. They should be prosecuted. We agree with you.

Foreclosures cost lenders $2000 to $3000 per case. Some lenders maybe can absorb that. Overwhelmingly, lenders don't want fore-

closures, don't want people losing their houses anymore than you or anybody else in this room does.

We, as an industry, want an actuarially sound FHA program based on the Price Waterhouse study. I think that has become the common denominator of what we have all come to accept as a respectable study. And it provides a range of options. And what I would say to you, Senator D'Amato, in response to some of your comments, in a sense, we don't think you go far enough.

Senator D'AMATO. I think you're right.

Mr. LASKO. But we disagree on what we mean by don't go far enough. And want to take this occasion just to make one simple point, and it goes back to Senator Cranston's opening comment about your attempt, Senator Cranston, to forge a compromise, if you will, during the Senate debate, which I watched very closely. And I watched both of you. And it was a fascinating debate.

And the one single point I want to suggest is that the Senate-passed bill actually allows a mortgage that exceeds the true value of the property. And, Senator D'Amato, you're right. And Mr. Weicher is correct. The critical point—and there are many others to be made about oilpatch risk and so forth—but the critical point is equity in the property.

And the way the Senate-passed bill is structured, because it allows that large up-front premium to be financed can give you cases, especially on low-balance loans, of up to, say, a 102 percent mortgage in relation to true value. And that's where I think you don't go far enough.

We as lenders say no mortgage should exceed the true value of the property. And that is why, in all sincerity, we say you don't go far enough. You should reduce that up-front premium. There are other proposals. And if not——

Senator D'AMATO. I don't understand. You say we don't go far enough, and I agree with that. Believe me, I would have pushed for more.

Mr. LASKO. You did. [Laughter.]

Senator D'AMATO. I was whittled away, and I would ask you to explain, what can we do to improve it.

Mr. LASKO. You could rely much more heavily on an annual premium and reduce the up-front premium. I believe the biggest problem in the structure of the FHA premium, and that is what we are here talking about, the biggest problem in the way the premium is structured is that too much is charged up front.

And as lenders the industry will tell you——

Senator D'AMATO. You're saying don't finance it?

Mr. LASKO. Don't charge it up front. Go to what is known as the Vento proposal——

Senator D'AMATO. Mr. Lasko, I'm not going to disagree with you about that, you know, in terms of one portion of it. But, on the one hand, you say you've got to get more people put more money up; right? On the other hand you say annualize this risk-based premium or the insurance. But you are not addressing the problem of getting more money up front.

Mr. LASKO. I believe I am, Senator.

Senator D'AMATO. How?

Mr. LASKO. Remember, in the Senate-passed bill, you can finance at 3.8 percent. You have a dilemma.

Senator D'AMATO. I would be delighted to say you can't finance it. Would you be happier with that?

Mr. LASKO. I would not, because I don't think that you go far enough in the——

Senator D'AMATO. If I said you had to put up the 3.8 percent, you had to finance it right up front, you had to have it included up front, what would you say to that? You wouldn't want that.

Mr. LASKO. The dilemma is this: you want to get people into houses.

Senator D'AMATO. I want to get people into houses who aren't going to have the likelihood as we do of the chance of 20 percent of them defaulting. And I'm saying let's take a picture of the 20 percent and look at it. And I think all of the studies, the Price Waterhouse study indicated it is as a result of people not having sufficient equity. It has little correlation with their earning.

If you look at the report, it is not the high-income or the low-income, but the correlation. As Mr. Weicher indicates, it is specifically addressed to how much equity do they have in that house.

Now help me deal with that problem. How do we deal with it?

Mr. LASKO. In the Senate bill, they walk into that house with as much as 2 percent negative equity——

Senator D'AMATO. I agree with you! So you want to support us putting more equity up or tell me how you're going to deal with that.

Mr. LASKO. OK, charge a 1.35 percent up front, and then charge an annual premium high enough to make the program actuarially sound, an annual premium which is obviously not financed. Charge it annually. Let them pay it on a pay-as-you-go basis, the way the private mortgage insurance companies do.

We think they do it right.

Senator D'AMATO. You say put 1.35 percent up front.

Mr. LASKO. That is a number right out of Price Waterhouse.

Senator D'AMATO. Cash. I have no problem with that.

Mr. LASKO. We would finance it.

Senator D'AMATO. You want to finance it? Let me ask you something: what have you changed?

Mr. LASKO. We have changed from the——

Senator D'AMATO. You have changed the financing part of that insurance.

Mr. LASKO. You have less mortgage in relation to the value of the property.

Senator D'AMATO. But we really haven't. OK, I understand that little part, and that is almost like a fiction, because that is the one part of the money that the Government gets back if they do default; right? They really do get that back.

But, let me ask you—yes, they do; they get the insurance premium; they will get that back—but how have we actually required—you are saying that the size of the mortgage has increased as a result of them financing that, but how have we gotten more equity into the thing.

Mr. LASKO. You have more—what you really have——

Senator D'AMATO. More of their own equity. You have reduced the mortgage by the result of not financing that insurance premium, but how have you gotten that person to put more equity into the property.

Mr. LASKO. In relation to the Senate-passed bill, where you actually have negative equity, where you've got a mortgage that exceeds——

Senator D'AMATO. I'm going to go back. I'm going to redraft this thing, and I'm definitely going to require more equity, you know, but I don't think you're going to be happy.

Mr. LASKO. Probably not. [Laughter.]

Senator D'AMATO. You really want them putting more equity in?

Mr. LASKO. We believe there is a better approach, and I mean it when I say you don't go far enough. Let's do it right. Let's go back to the pre-1984 arrangement where the program was on a pay-as-you-go basis. And obviously it hadn't hit the problem yet of this big up-front premium that gave you mortgages, whether in the southwest or the northeast or California, mortgages that exceeded the value of the property going in the day people moved in.

You can get away from that with a simple rule that the mortgage cannot exceed the value of the property. Thank you, Senators, for letting me speak.

[The complete prepared statement of Warren Lasko follows:]

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STATEMENT OF

Warren Lasko

Executive Vice President

of the

MORTGAGE BANKERS ASSOCIATION OF AMERICA

before the

SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

of the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

Hearings on

Federal Housing Administration
Mutual Mortgage Insurance Fund

July 24, 1990

Mr. Chairman and Members of the Subcommittee, I am Warren Lasko, Executive Vice President of the Mortgage Bankers Association of America (MBA).* Accompanying me today are Michael Ferrell, MBA's Senior Staff Vice President and Legislative Counsel and Sharon Canavan, MBA's Deputy Legislative Counsel.

MBA appreciates the opportunity to appear before you today to testify with respect to the Federal Housing Administration's (FHA) single family homeownership mortgage insurance programs, which are administered under the Mutual Mortgage Insurance Fund (MMIF). As responsible representatives of the industry that makes over 75 percent of all FHA loans, MBA believes we have unique insight into what has made the program a success over most of its 56 years, and into what has caused its problems in recent years.

The focus of HUD and the Congress over the past 18 months has been on FHA's financial condition. This is appropriate, but it is only half of the equation. Any fundamental reassessment of the structure of the FHA home loan program should balance: (1) the role and need of FHA in serving its mission to promote home ownership, against (2) the limits on financial risks and the suitable pricing structure needed to sustain a self-supporting mortgage insurance program. We believe the recent Senate passage of FHA reforms in S 566, the "National Affordable Housing Act" have focused exclusively on the latter, to the great sacrifice of the basic mission of the program.

FHA's actuarial performance over the past decade is not dissimilar to that of private mortgage insurance companies, and in a broader sense reflects the financial performance of virtually all participants in the real estate finance industry. The entire mortgage industry, along with FHA, learned expensive lessons from the economic reversals that beset energy-dependent regions of our country during the 1980s. FHA losses in recent years in substantial part reflect claims on loans made in the oil and other energy-based states. FHA was pursuing its historic mission to assure the availability of home mortgage credit in all regions of the country, while private mortgage insurance firms in good part withdrew from regions where house prices appeared weak. While arguably FHA's underwriting guidelines should have been modified to adapt to changing economic circumstances in specific regions during the 1980s, it cannot be denied that the FHA program helped sustain and preserve viable housing markets in distressed areas, while private firms virtually abandoned many communities already in economic distress.

MBA recognizes that FHA cannot conduct business in the next decade as it did in the one just past. We support changes to the FHA program based on the Price Waterhouse recommendations to improve the financial condition of the MMIF. The Price Waterhouse study presented a range of program restructuring options aimed at preventing declines in the FHA mortgage insurance fund and preserving adequate financial reserves for the future. The Senate-passed bill, which reflects in good part the proposals made by HUD Secretary Kemp for restructuring FHA, is drawn from the range of options developed by Price Waterhouse.

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* The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of residential and commercial real estate finance. MBA's membership comprises mortgage originators and servicers, as well as investors, and a wide variety of mortgage industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, selling, and servicing real estate investment portfolios. Members of MBA include:

- Mortgage Banking Companies
- Commercial Banks
- Mutual Savings Banks
- Savings and Loan Associations
- Mortgage Insurance Companies
- Life Insurance Companies
- Mortgage Brokers
- Title Companies
- State Housing Agencies
- Investment Bankers
- Real Estate Investment Trusts

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But within their range of options, we strongly believe there are possibilities far more attuned to promoting homeownership, consistent with financial soundness for FHA, than those contained in the Senate bill. Our concern is that the specific remedies adopted in S 566 are driven by fiscal and budgetary interests to the detriment of FHA's basic social purpose and historic mission.

The risk-based premium pricing structure adopted in S 566 will establish hurdles to homeownership for the very people FHA is most intended to serve. Also, by substantially increasing the up-front cash requirement to close a loan, the Senate-passed bill creates the very obstacle these people have most difficulty in overcoming--accumulating sufficient cash for down payment and closing costs.

MBA estimates that the consequence of adopting the Senate approach is that up to 1.1 million current renter families who are potential home buyers will be denied the opportunity to buy a home. The home ownership rate for households headed by an individual aged under 35, which already declined seven percent over the past decade, will decline still further if the Senate-passed approach is adopted. The problem is exacerbated for minorities. Available data indicates that only about 1.5 percent of minorities could qualify for a typical starter home loan, and that their typical net worth is well below that of average white households in the same age and income range.

Our deepest concern centers on the plan for a risk-based FHA mortgage insurance premium structure. It has been a long-standing and fundamental principle of the FHA premium structure to cross-subsidize the risks of very modest income first-time buyers with excess premium collections on higher downpayment loans usually made to middle income families buying higher priced homes. A risk-based premium structure, while based on sound business principles, flies in the face of sound public policy and the basic FHA mission. The adoption of a risk-based premium structure will almost undoubtedly render FHA loans too expensive to afford for those who most need and can benefit from the FHA home ownership program. It will increase costs for families that can least afford to pay more. The fact is, the existing flat premium for all borrowers is simple and it works. The proposed new structure is complex to administer and faces a real prospect for failure.

A second concern with the Senate approach is that it continues to rely on a large (3.8 percent) up-front premium. The Price Waterhouse study documents, and the lending industry can attest, that the large up-front mortgage insurance premium undermines the actuarial soundness of the FHA program. Consequently, MBA strongly endorses a move toward increased reliance on annual premiums over the life of the loan, and reduced reliance on an up-front premium. This is how it was done before 1984, and it is how the private mortgage insurance industry prices its coverage.

Finally, we believe that the FHA program must be designed to continue to appeal to borrowers who are good credit risks as well as to serve the needs of those borrowers, particularly first time borrowers. (In the first quarter of 1990, 81 percent of FHA mortgage insurance was for first time borrowers.) FHA must offer an attractive, competitive product or it will run the real risk of becoming the mortgage insurer of last resort.

S 566 disallows the financing of a significant portion of the closing costs and substantially increases the FHA mortgage insurance premium, adopting a "risk-based" premium that focuses solely on the risk represented by a lower vs. higher downpayment. No low-risk borrower would rationally *choose* this FHA loan. So FHA loans would be available only where borrowers had *no choice*. If this approach is adopted, borrowers would seek FHA loans only where FHA was the only mortgage credit choice available.

FHA will be the only mortgage insurer remaining in economically depressed regions that have been deserted by private mortgage insurers. In fact, that is a large part of the reason FHA faces such troubles today. FHA stayed in oil patch states when they were virtually deserted by the private mortgage insurers. From 1985 through 1987, the five oil patch states (Texas, Alaska, Colorado, Louisiana, and Oklahoma) comprised 19% of FHA's loan production volume, but resulted in 46% of the claims paid for FHA loans insured during this period. No reasonable underwriting changes, short of stopping FHA lending in these areas, could have avoided these losses.

An article published in the June issue of Mortgage Banking magazine, written by the executive vice president for risk managment at Mortgage Guaranty Insurance Corporation, entitled "The Local Nature of Housing" outlines how a private mortgage insurance company has implemented regional underwriting guidelines. "Real estate markets in the energy states precipitated the use of regional underwriting guidelines. The need for special, more restrictive, guidelines in these markets ultimately became obvious in the past decade after the widespread occurrence of property value declines." MGIC has developed underwriting guidelines to "govern various geographic territories ranging from one state at the broadest level to one county at the most targeted level. When applied to an entire MSA, the guidelines apply to the various counties that comprise the MSA."

Quoting again from that article in a discussion of whether varying risks can be addressed by pricing a premium, the author concludes, "Based on MGIC's experience, the premium required to actually insure the loss in distressed areas would be greater than the market could bear." Is that what this Congress should endorse--a Federal program designed to insure loans only where a rational businessman chooses not to insure loans? That is a prescription for disaster.

While S 566 is characterized as adding to soundness, it could, albeit unintentionally, produce opposite results. If FHA's fees are higher, the out-of-pocket cash requirements are similar, and the downpayment requirement is similar to private mortgage insurance, then FHA would be similar or worse for borrowers in all major respects except one--FHA would remain available nationwide. So borrowers in healthy markets would choose the cheaper, equivalent product--private mortgage insurance. Borrowers in economically depressed markets or in areas redlined by the private mortgage insurance industry would have nothing but FHA mortgage insurance to which to turn. FHA would be writing insurance only where private mortgage insurance requirements were stiff or where private mortgage insurance on any terms was unavailable.

FHA: The Road To Recovery

MBA recognizes that FHA cannot conduct business in the next decade as it did in the 1980s. The entire industry learned an expensive lesson from the economic problems that beset regions of our country. No longer will high rates of property appreciation and inflation make mortgage lending seem risk-free. FHA, like the rest of the industry, must adjust to these new market dynamics.

However, just as FHA must react to changing conditions in the marketplace, it cannot ignore its social purpose. Where private companies can simply stop doing business in certain areas, FHA's responsibilities are far more complex. It must strive to reach a delicate balance between making prudent business decisions and helping deserving Americans achieve homeownership.

This testimony analyzes important statistical information which must be considered in the development of new initiatives to improve the FHA program. Our key findings are:

1. Despite its foreclosure problems, FHA's mortgage portfolio was extremely well-diversified by loan-to-value ratio during the 1980s. For the period FY 1981-1988, low downpayment loans (above 95 percent loan-to-value ratio) comprised only 25 percent of FHA's new originations. Even in FY 1988, low downpayment loans made up only 33 percent of FHA's business. (Table 1)

2. Lower income families use low downpayment loans more frequently than any other group. Almost three times as many low downpayment FHA loans were made on mortgages of less than $50,000 than were made on mortgages above $80,000. (Tables 2, 3)

3. While FHA's book of business for the period 1979-1985 is performing poorly, the 1987 insurance, which is FHA's highest volume year, is performing extremely well. The good news about the 1979-1985 years is that claims are now declining and the worst is over. Since 65 percent of FHA's outstanding loans were originated after 1985, FHA's solvency in the 1990s will be determined by how well these recent mortgages perform. In light of the program improvements that have been

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made in the FHA program in the last several years culminating with the passage of the HUD Reform Act, these mortgages should perform much better than earlier years. (Table 4)

4. Property location continues to be a primary cause of foreclosure. Mortgages originated in the five major "oil patch" states comprise 19 percent of FHA's originations in the period from 1985 to 1987 and 46 percent of the claims on all loans originated during this period. The FY 1986 book of business is extremely profitable for FHA if the five states are excluded. Clearly, location plays a significant role in causing foreclosures. Arguably, no reasonable underwriting changes short of stopping FHA lending in these areas could have avoided these problems. (Table 5)

5. Lower balance loans are more risky. Mortgages below $50,000 are the most risky loans for FHA. Higher balance loans are needed to cross-subsidize these loans. (Tables 6 and 7)

6. Claims are occurring in later policy years. Probably no other data in this report demonstrate more clearly the uniqueness of the problem that occurred in the 1980s. Where the second policy year always had the highest number of claims during the period 1970-1978, from 1979 to the present, claims have increased on seasoned loans. FHA's 1979 originations document this problem. Claims peaked in the fourth year, started downward, and then began rising in the eighth year and reached the highest level in the ninth year. (Table 8)

MBA Recommendations

HUD and the Congress have acted to address some of FHA's problems with the passage and implementation of the HUD Reform Act in 1989. That legislation banned investor loans and required credit reviews on assumption purchasers. These types of loans had produced considerable losses for FHA. One internal FHA document in 1986 estimated that investor loans comprised about 8 percent of FHA's volume and 25 percent of its early defaults.

The recent Price Waterhouse report indicates that further changes are necessary to put FHA on a sound footing in the 1990s. However, it would be inappropriate to discuss possible future courses of actions without considering FHA's social responsibilities. Numerous studies have documented the affordability problem facing our country. Homeownership rates have continued to decline during the 1980s. Harvard University's Joint Center for Housing Studies 1990 Report noted that this problem is particularly severe for married couples with children between the ages of 25-34. For this category which comprises many first-time homebuyers, the homeownership rate dropped from 71.1 percent in 1980 to 63.8 percent in 1989.

Lower income families purchasing homes under $50,000 use FHA financing more frequently than the purchasers of higher priced homes. While there are greater risks with this category of borrowers, FHA must maintain an effective balance between developing policies to ensure financial solvency and meeting the homeownership needs of these deserving families.

At the same time, it appears that FHA cannot remain financially solvent if it continues to sustain claims in the 1990s at the rate they occurred during the 1980s. The critical issue becomes what was the source of FHA foreclosure problems---structural provisions of the program (e.g. premium levels, downpayment requirements) or external factors (e.g. regional economic problems.)

In almost every loan-to-value category from 1981-1986, the FHA fund lost money whether the borrower made the smallest downpayment possible or made a cash investment of more than 10 percent. It is clear that forces other than the downpayment amount were at work during the 1980s.

Whether it was the fact that an unprecedented number of claims were received on seasoned loans or claim rates varied by more than 300 percent for the same category of loan depending on the property's location, it is obvious that the regional economic problems that have hounded the "oil patch" states throughout the 1980s have been like a tidal wave leaving a battered real estate industry in its wake. There appears to be no other explanation for the phenomenon, which causes the

number of claims for 1979 originations to peak in the fourth year, start down and then, in the ninth policy year, rise again to the highest number of claims for that book of business. No reasonable structural, underwriting or programmatic change could have avoided that problem.

But FHA cannot dismiss what happened in the 1980s as solely the result of a catastrophic economic disaster that will not reoccur. To ensure that FHA remains financially strong in the next decade, MBA believes that FHA should take a variety of actions. MBA recommends the following:

FHA Maximum Mortgage Limits. FHA maximum mortgage amount should be increased to 95 percent of median sales price for an area up to 85 percent of the Fannie Mae/Freddie Mac limit. FHA must spread its risk of possible loss across as large a group of policyholders (mortgagors) as possible . Data from FHA and VA show claim rates drop as the loan amount increases.

Like any insurance company, FHA must spread its risk of possible loss across as large a group of policyholders (mortgagors) as possible. In the last ten years, FHA's ability to spread its risk has been limited because of the FHA maximum mortgage ceiling. The following table demonstrates the decline of the FHA mortgage limits as compared to existing housing median sales price.

Comparison of
FHA Maximum Mortgage Amount to
Existing Home Prices

Year	Existing Housing Median Sales Price*	FHA Mortgage Ceiling	FHA Ceiling as Percent of Median Sales Price
1969	$21,800	$33,000	151%
1974	$32,000	$45,000	141%
1977	$42,900	$60,000	140%
1979	$55,100	$67,500 ($90,000 in high cost area)	123%
1987	$85,600	$67,500 ($101,250 in high cost area)	79% (up to 95% in high cost area)
1989	$93,100	$67,500 ($124,875 in high cost area)	76% (up to 95% in high cost area)

* National Association of Realtors data

FHA limits as a percentage of median sales price have dropped dramatically in the last 20 years. Data for 1987 and 1989 demonstrate how quickly the mortgage limits are declining in real terms.

In addition to providing FHA financing and homeownership opportunities to families in high cost areas, FHA needs these increased limits to ensure that it can remain actuarially sound. High balance loans have lower claim rates and cover the costs associated with claims on lower priced homes as well as homes in economically distressed areas.

Revision of the Mortgage Insurance Premium (MIP) Structure. HUD implemented the one time mortgage insurance premium in August 1983. Designed to provide the Federal Government with an immediate influx of revenue of up to $3 billion per year, this program permitted the financing of the upfront fee of 3.8 percent in the mortgage. (While FHA collected the premium at closing, it earned the premium on a yearly basis commensurate with expected losses.)

The financing of the MIP, coupled with FHA's downpayment requirements, permitted FHA mortgages in some cases to exceed the appraised value of the property. In light of the correlation

between mortgage risk and LTV, many contend that the one time premium should be eliminated and HUD should return to a monthly payment of mortgage insurance premium.

MBA supports the proposal, HR 5266, offered by Representatives Vento (D-MN) and Ridge (R-PA). It is attractive, because it reduces risk without so dramatically increasing the borrower's cash requirements. It also recognizes the budget impact of a conversion back to greater reliance on a monthly premium payment. The proposal converts the current upfront fee to a hybrid system requiring an upfront fee with subsequent additional monthly premium payments. MBA's fundamental concern with any proposal is its impact on homebuyer affordability. As a result, under a hybrid proposal, we believe that the upfront portion of the premium should be financable. Finally, MBA supports this proposal because it maintains the uniform premium pricing structure of the FHA program.

Modification of Distributive Share Payments. FHA's single family program is a mutual insurance program under which program participants can receive distributive shares after their loans are paid off, depending on how their book of business has performed. In FY 1989, FHA paid approximately $170 million in distributive shares. MBA believes that the mutuality feature should be modified to provide for payment of distributive shares only if the entire MMIF is sound--not if a particular year's business was sound.

Capital Ratios for MMIF. MBA supports the goal of 1.25 percent capital for the MMIF, which is considered adequate by Price Waterhouse. We believe that the timetable for achieving that goal should be established in accordance with FHA being able adequately to address its program mission. We also support an annual audit of the MMIF by an independent accounting firm to ascertain its solvency and address emerging concerns.

Development of An Early Warning System for Declining Markets. FHA's experience in the 1980s proves that a property's location is a critical determinant in the mortgage risk equation. Unfortunately, it is difficult, if not impossible, to predict which markets will decline in the 1990s. Moreover, if FHA does designate an area as a "softening market", it could result in a self-fulfilling prophecy as FHA's action could lead to a downturn regardless of the actual strength of the market.

In addition to these market identification problems, there is also the concern that if FHA leaves a market no matter how valid that decision may be from a business perspective, the problems will only be more severe for the area. Another problem with regional underwriting is the question of when should restrictive requirements be lifted. Many would contend that the "oil patch" states' economies are now improving and house prices are rising. When should standard criteria be used again in affected areas? FHA's social responsibility must be factored into this discussion.

However, FHA's claim losses on the FY 1985, 1986, and 1987 books of business cannot be ignored. The five "oil patch" states comprise 19 percent of FHA's originations and 46 percent of the claims on all loans originated during the period. By 1985 or 1986 at the latest, economic problems in the "oil patch" states were well documented and HUD could have avoided some of its claim problems if program tightening had taken place even at that time.

In conclusion, this issue is extremely complex. There is no doubt that HUD's claim problems in the 1980s are tied to the economic problems of the "oil patch" states. Accordingly, MBA believes that this proposal should be explored in greater detail. Between the two extremes of using the same program criteria in all parts of the country regardless of economic conditions and shutting down FHA activity in specific markets, there may be reasonable actions that FHA can take to balance its concerns for financial soundness and serving deserving homebuyers.

Distribution of HUD Default and Claim Data. MBA believes that HUD should distribute default and claim reports to originating lenders. MBA also believes that HUD should track loan performance by loan origination officer and publish similar reports.

In 1986, HUD began monitoring lender default and claim percentages by field office jurisdiction and comparing individual lender performance with field office and national default and claim averages. HUD uses this information to identify lenders for reviews by outstationed FHA mortgage monitoring staff. On an annual basis, HUD also requests explanations from lenders with default rates 20 percent higher than established norms.

With the substantial increase in the number of servicing transfers over the last several years, it is difficult for originating lenders to track their FHA origination performance. Distribution of this information to the originating lender would be extremely helpful. An important by-product of this action would be that prospective wholesale purchasers of FHA loans could request an originating lender's HUD "report card" before agreeing to purchase the lender's FHA loans. In this way, the marketplace can assist FHA in improving the quality of its product.

Lender Eligibility Standards. FHA has expressed concern about the financial capability of lenders to honor their responsibilities. It argues that the relative ease of entry into the FHA program could permit a company with minimal net worth to originate poor quality loans and then expose HUD, in theory, to considerable financial losses.

While MBA understands the arguments supporting increased lender net worth requirements, MBA is deeply concerned that a unilateral increase in net worth will arbitrarily exclude many well-qualified, smaller companies. For that reason, MBA recommends that the cornerstone of FHA's new lender eligibility standards must be a sliding scale formula tied to a lender's volume of FHA retail and purchased originations. MBA's recommendations for Direct Endorsement eligibility are:

FHA Annual Volume Retail and Purchased Originations	NetWorth
Under $50 million	$250,000
$50 to $100 million	$300,000
$100 to $250 million	$600,000
$250 million or more	$1 million

Lender Selection of the Appraiser. The HUD Reform Act of 1989 expanded the Department's authority to levy civil and monetary penalties. HUD is requiring lender indemnification against possible FHA losses in an increasing number of cases. While HUD is holding the lender more accountable for the mortgage origination process, lenders under the Direct Endorsement Program still do not control the entire process (selection of the appraiser) even though the program's success has exceeded all expectations.

Lenders want appraisers who provide quality appraisals in a timely manner. Unfortunately, under the current process, lenders can be assigned appraisers who perform inferior work and do not meet time constraints mandated by the real estate broker, builder, buyer or seller. While lenders can report problem appraisers to the local field office, this process does not work effectively. Lenders do not believe their complaints will result in any meaningful action.

MBA believes qualified lenders should be able to select the appraiser of their choice. Eligible lenders would have to meet acceptable default and claim performance standards. Lenders would also meet appropriate equal opportunity responsibilities. Lenders would accept responsibility for the quality of the appraisal consistent with industry standards (e.g. Fannie Mae and Freddie Mac).

SUMMARY

MBA appreciates the opportunity to testify before this Subcommittee and will provide answers to questions or requests for additional information, as requested, for inclusion in the hearing record.

TABLE 1

FHA Mortgage Portfolio Diversified by Loan to Value (LTV) Ratio. From a risk perspective, it is important that mortgages are not concentrated in the high loan-to-value category. The following table provides the percentage of FHA mortgages by loan-to-value category. Mortgages insured for each fiscal year are provided for comparison purposes.

Percentage of FHA Mortgages By Loan-to-Value Category--FY 1981 - 1988

Fiscal Year	Above 90 Percent	90-95 Percent	80-89 Percent	Below 80 Percent	Total Mortgages
1981	18	19	25	38	273,789
1982	17	22	25	35	173,034
1983	16	22	24	40	513,435
1984	29	26	25	20	336,956
1985	25	27	30	18	371,541
1986	25	27	29	19	793,684
1987	24	30	27	18	1,354,136
1988	33	35	20	11	778,772
Total	25	28	26	21	4,595,347

For mortgages insured during the 1981-1988 period, loan-to-value ratios were fairly evenly distributed throughout the four categories. In 1988, there was an increase in loans with LTVs above 95 percent. However, it still remains only one-third of FHA's total FY 1988 volume.

Source: HUD A-43 System

TABLE 2

A review of the 1,128,721 FHA mortgages with loan-to-value ratios above 95 percent indicates that 428,870 (38 percent) were made on mortgages of less than $50,000. Only 160,652 (14 percent) of these low downpayment loans were made on mortgages above $80,000. The following table provides a breakdown by year for these two categories. (FHA statutory mortgage limits were raised to $90,000 in 1979 and subsequently increased to $101,250 in 1987 and $124,875 in 1989.)

FHA Low Downpayment Mortgages (Above 95 Percent LTV) By Mortgage Amount--FY 1981- 1988

Fiscal Year	Mortgages Under $50,000 Greater Than 95% LTV	Mortgages Over $80,000 Greater Than 95% LTV	Total Mortgages Over 95% LTV
1981	36,066	321	49,216
1982	20,362	652	30,266
1983	40,872	3316	80,439
1984	43,189	7179	96,894
1985	34,448	13,776	93,917
1986	63,380	33,043	196,168
1987	97,521	56,034	321,195
1988	93,032	46,331	260,626
Total	428,870	160,652	1,128,721

There were more than twice as many FHA insured mortgages made under $50,000 than were made over $80,000 during the eight year period.

TABLE 3

The following provides a more detailed breakdown of the distribution of the number and percentage of mortgages with LTVs above 95 percent by loan amount for the last three years (1986-1988).

Number and Percentage FHA Low Downpayment Loans (Above 95 Percent LTV Ratios) By Loan Amount-- FY 1986 - 1988

Mortgage Amount	1986 Mortgages	1986 Percent	1987 Mortgages	1987 Percent	1988 Mortgages	1988 Percent
under $50,000	63,380	32	97,521	30	93,032	36
$50,000 to $59,999	34,071	17	56,023	17	43,805	17
$60,000 to $69,999	35,362	18	61,196	19	42,623	16
$70,000 to $79,999	30,312	15	50,421	16	34,835	13
$80,000 to $89,999	23,298	12	39,935	12	27,831	11
Above $90,000	9,745	5	16,099	5	18,500	7
Total	196,168	100*	321,195	100*	260,626	100

* Do not equal 100 due to rounding

Approximately 50 percent of these low downpayment were made on mortgages less than $60,000. Only about one-third of the mortgages with downpayments of less than 5 percent exceeded $70,000.

Source for Tables 2 and 3: HUD A-43 System

TABLE 4

FHA has experienced an increasing number of foreclosures/claims on mortgages insured during the 1980s. The following table provides the cumulative claim rates for endorsement years 1979-1988.

Section 203(b) 30 Year Term Cumulative Claim Rate (Data through 9/89)

Endorsement Year	Claim Rate	Endorsement Year	Claim Rate
1979	8.59	1984	14.01
1980	13.31	1985	9.92
1981	19.58	1986	3.93
1982	16.09	1987	1.02
1983	11.47	1988	.29

While foreclosure problems are most severe for the books of business from 1980 to 1984, all of the years from 1979 to 1985 are performing poorly and are losing money for FHA. The performance of the 1986 and 1987 mortgages are analyzed in more detail below. The following table provides claim data for loans insured in FY 1985-1987. (It is too early to make meaningful conclusions about 1988 and 1989 endorsement years.) Also included is the estimated claim rate at which FHA generates net revenue for each particular year.

FHA Loan Experience--FY 1985-1987

Fiscal Year	Mortgages Insured	Claims Paid through 12/89	Cumulative Claim Rate	Estimated Claim Rate to Generate Revenue
1985	371,478	42,399	11.41	5.6
1986	794,021	43,351	5.46	4.8
1987	1,354,432	26,964	1.99	3.7

Both FY 1985 and 1986 books of business are currently losing money for the FHA fund. The FY 1987 book is performing much better and continues to have a claim rate that is almost 50 percent below the level at which FHA makes a profit.

Source: HUD A-43 System

TABLE 5

FHA Claim Rates By LTV* 1981-1986

The amount of downpayment has always been considered a critical variable in determining mortgage risk. The following table provides FHA claim rates by LTV for 1981-1986 originations.

	Above 95% LTV	90 to 95% LTV	85 to 89% LTV**	80 to 84% LTV	Below 80%	Total Claim Rate
1981	27.3	19.6	14.6	15.1	12.8	17.2
1982	31.4	22.2	14.8	15.7	12.1	18.5
1983	19.9	14.2	9.1	10.2	7.3	11.3
1984	19.4	13.8	9.9	12.7	6.2	13.3
1985	14.0	10.1	10.5	11.1	4.0	10.1
1986	6.2	4.5	4.4	4.4	1.6	4.3

* Claims Paid Through May 31, 1989

** Category 85-89% LTV permits analysis of high downpayment owner occupant loans. FHA investors had to make downpayments of at least 15 percent. Most investor loans are in 80-84% LTV category.

While claim rates are lower as the borrower's downpayment increases, every LTV category from 1981 to 1985 with the possible exception of LTVs below 80 percent in 1985 lost money for FHA. Not until 1986 does the LTV category below 80 percent perform well and earn money for FHA.

TABLE 6

Critics of FHA have stated that mortgages with higher loan balances have greater risk than low balance loans. The following table offers evidence to the contrary.

FHA Claim Rates By Mortgage Amount (By Fiscal Year of Origination For First 3 Policy Years)

	FY 1984	FY 1985	FY 1986*
Under $50,000	9.11%	8.96%	5.31%
$50,000-60,000	7.45	8.00	4.45
$60,000-70,000	7.38	7.54	4.07
$70,000-80,000	6.12	7.33	3.94
$80,000-90,000	5.69	6.68	3.74
Above $90,000	6.54	7.76	4.15
Total Claim Rate	7.86	8.03	4.43

*1986 estimate based on figures through May 1989.

Source for Tables 6 and 7: HUD A-43 System

TABLE 7

As demonstrated in the following table, if mortgages in the three oil states are excluded, the claim rates on mortgages over $90,000 is at least 30 percent better than any other category.

FHA Claim Rate Percentage On Mortgages Above $90,000 By Fiscal Year of Origination

	FY 1984	FY 1985	FY 1986
Alaska	51.40	50.03	26.50
Colorado	18.95	14.98	6.55
Texas	20.43	14.79	8.59
Total Claim Rate	6.54%	7.76%	4.15%
U.S. (excluding 3 oil states)	3.72	2.37	1.51

Source: HUD A-43 System

While the claim rate steadily declines as the mortgage amount increases, the claim rates for above $90,000 are higher than claim rates for the $70,000 and $80,000 categories. However, the numbers in the above $90,000 category are heavily skewed by mortgages originated in Alaska and, to a lesser degree, in Texas and Colorado. Although FHA does a small percentage of its business in Alaska (1% of 1988 insurance), loans above $90,000 are concentrated there, because of the high cost exemption that allows FHA to insure mortgages up to $135,000 on single family homes in Alaska.

TABLE 8

Claims Are Occurring Later. For every endorsement year from 1970-1978, the highest number of claims occurred during the second policy year. During the 1980s, claims are occurring later in the loan cycle. The following table documents this change for the period from 1979 to 1988.

Claims for Section 203(b) 30-Year Term by Policy Year and Endorsement Year

Policy Year #	Endorsement Year 1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
1	572	779	891	822	871	707	961	1192	1460	749
2	2356	3100	4944	3541	5671	5267	8173	10,287	8490	
3	2373	3945	4588	4071	8819	7743	13,334	14,835		
4	2424	3626	3869	4003	9968	7821	10,614			
5	2223	3180	3308	3482	10,623	5490				
6	2106	3128	2796	2490	8010					
7	2183	3228	2374	1486						
8	2254	3338	1505							
9	2610	2521								
10	2114									

Source: HUD Actuarial Data through September 1989.

In every year except 1981, the highest number of claims was in the third year or later. However, claim activity for 1979 and 1980 originations underscore the anomaly of this period. In both 1979 and 1980, claims peaked in the fourth and third year respectively, started downward, then increased in years nine and eight. In looking for the cause, lender origination and underwriting practices are clearly not part of this problem. Claims on seasoned loans could not have been forecast at the time of loan origination.

Many contend that increased claims in later policy years are another example of the devastation caused by the economic problems that plagued the oil states in the 1980s. Property depreciation eroded equity that had been built up and once homeowners lost jobs as a result of the economic problems, foreclosures were inevitable even on seasoned loans.

MICHELLE MEIER, COUNSEL GOVERNMENT AFFAIRS, CONSUMERS UNION, WASHINGTON, DC

Ms. MEIER. Senator D'Amato, you get more equity in both cases if you're allowed to finance the insurance premium, the up-front insurance premium, but in one case the up-front insurance premium is less than in the other case, which is true between the Cranston proposal and the administration's proposal.

You're going to have a lower loan-to-value ratio under the Cranston proposal because the insurance premium is lower.

Senator D'AMATO. Do you want to know something? That doesn't really concern me. That really doesn't go to the heart of this thing and, Mr. Lasko, you're going like this and I'm going like this——

[Demonstrating.]

I'm going to ask the Price Waterhouse, if we were to adopt that lowering of the premium from 3.8 percent to 1.35 percent and not require more up front of costs, will we be lowering the default rates if we don't require more cash up front.

[The prepared statement of Michelle Meier follows:]

Consumers Union
Publisher of Consumer Reports

Testimony of

Michelle Meier

Counsel for Government Affairs

Consumers Union

on Proposed Changes to FHA Program

Subcommittee on Housing and Urban Affairs

Committee on Banking, Housing and Urban Affairs

U.S. Senate

July 24, 1990

Consumers Union[1] appreciates the opportunity to testify today on the proposals that have been offered to modify the FHA insurance program for single-family purchases. Over the years, this program has been one of the key tools by which many families have climbed into the American dream of homeownership. We are extremely concerned that the programmatic changes proposed by the Administration will **unnecessarily** create new barriers to homeownership at a time when the existing barriers are already insurmountable for many young families. If Congress decides to forge ahead with any changes at this time, we believe the approach proposed by Senator Cranston, and Congressmen Vento and Ridge in the House, are far preferable.

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[1] Consumers Union is a nonprofit membership organization, charted in 1936 under the laws of the State of New York to provide information, education, and counsel about consumer groups and services and the management of family income. Consumers Union's income is derived solely from the sale of Consumer Reports, its other publications and films. Expenses of occasional public service efforts may be met, in part, by nonrestrictive, noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, Consumer Reports, with approximately 4.5 million paid circulation, regularly carries articles on health, product safety, marketplace economics and legislative, judicial and regulatory actions with affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

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The Price Waterhouse Report Needs Careful Study - It Does Not Even Attempt To Analyze The Effect Managerial Reform At HUD Will Have On The Actuarial Soundness Of Future FHA Business.

We are also greatly disturbed by the haste with which the Administration is pressing its proposed changes. The Administration only unveiled its proposal, and the Price-Waterhouse study on which it is based, in June. Immediately, it began pressing for Congress to adopt its proposal on the floor.

Changes that will significantly restrict the availability of a program designed to achieve important social goals should not be made "on the fly." They should be made only after the source of whatever problems might exist has been carefully identified and full consideration is given to alternative approaches to minimize or reduce these problems. The preferred alternative, of course, is the one that will address the problems with the least amount of burden to the intended beneficiaries of the program.

According to HUD, the problem that must be addressed is the possible insolvency of the FHA insurance fund within the next two or three decades. A principal cause of the problem, according to the agency, is the high loan-to-value (LTV) ratios allowed in the current program and the effect of these values on future anticipated claims against the MMI fund. HUD's solution is to impose both higher up-front cash requirements on FHA borrowers to lower their true LTV ratios and to impose annual insurance premiums in addition to the steep initial premium that is already required.

Although we support the goal of keeping the MMI fund solvent even in relatively adverse economic environments, let's not jump to hasty conclusions regarding the current ability of the fund to meet this goal. The conclusions reached by Price-Waterhouse might very well be right -- if current practices continue, the fund might be unable to withstand moderately severe adverse conditions in the future. However, major policy decisions should not be based on the uncritiqued analysis of one organization, particularly given the flawed data Price Waterhouse was forced to use, and the limited analyses it conducted.

The importance of carefully analyzing the conclusions Price Waterhouse reached on this key threshold question is all the more urgent in light of the rumors now circulating that FHA has enjoyed net earnings, rather than net losses, during the first 6 months of this year. We believe that HUD should fully respond to these rumors immediately.

Assuming that the FHA fund faces possible insolvency, we also question the consultant's conclusions that the high LTV's ratios permitted under the current FHA program is its principal cause. High LTV ratios may increase default risk, but not necessarily to

levels that are unreasonable given the social and financial goals of the MMI fund program. Other factors, which the Price Waterhouse report does not even consider in its analysis of future losses, may account for the unacceptable level of FHA defaults during the eighties.

For example, one of the major causes of the high losses during the eighties may be HUD's lax monitoring and neglect of the FHA program during the same period. These problems have been well-established, with the local "Robin HUD" case being one of the more poignant examples. As recently as last fall, GAO reported that HUD had not implemented many of the financial management reforms recommended by the GAO and HUD's internal Committee on Fraud, Waste, and Mismanagement in 1984:

> In 1984, GAO recommended the Secretary improve HUD's monitoring of program participants. Also, in 1984, HUD's internal Committee on Fraud, Waste, and Mismanagement recommended that all HUD program offices should aggressively pursue monitoring of program participants.

Even so, there is evidence of a lack of monitoring throughout HUD. You can read about it in the newspaper as well as see it in the potential weaknesses we have identified in our current review of FHA's monitoring of insured single-family loans. We have found the following potential weaknesses:

> -- FHA's system is incomplete for monitoring regional and field offices, lenders, fee appraisers, and counseling agencies. The system does not include all necessary monitoring to ensure that lender quality control plans are adequate, sanctions are taken for poor performance, and appropriate management uses are made of the results of monitoring.
>
> -- FHA does not have a system for tracking all required monitoring to ensure that it is performed, or that the results of monitoring activities are used as required.
>
> -- FHA does not have a complete and reliable system for tracking audit findings and recommendations. Hearings before the Housing Subcommittee, Committee on Banking, Housing, and Urban Affairs, U.S. House of Representatives (September 18, 1989) at pp. 21-22 (response by Dennis Duquette, U.S. Government Accounting Office, to question submitted by Hon. Henry Gonzalez).

Although the Price Waterhouse study shows a direct historical correlation between FHA loans with high LTVs and those that went into default, it does not even attempt to show whether the high LTV loans that went into default conformed with the underwriting standards HUD requires. In other words, a high LTV ratio may not be the key determinant of unacceptable default risk. The key culprits may be lax or even fraudulent underwriting, including inflated appraisals.

We can only make conclusions about the relationship between high LTVs and default if the analysis excludes data about loans that might have gone into default for other reasons. For example, such an analysis would eliminate improperly underwritten loans from the total pool of high LTV ratio loans that went into default during the eighties. With this historical data, we could begin to forecast future default rates among high LTV borrowers in the well-managed, fraud-free program that the public expects HUD to ensure for the future.

It is totally inappropriate to restrict the program by making it less available to needy borrowers until we know what is really the major cause of the losses in the eighties. It is also unfair to saddle future program participants with burdensome program changes if past government fraud, waste, mismanagement and abuse are the major cause of the projected future losses motivating the changes. Although the FHA program should be structured to meet the goal of solvency, we should not impose new burdens on FHA borrowers if we can meet that goal by cleaning up HUD's management of the current program.

Assuming programmatic changes are necessary, those proposed by the Administration are unnecessarily burdensome to future FHA borrowers. Even assuming that the MMI fund is actuarially unsound, and that its weakness is directly related to current underwriting standards, the programmatic changes proposed by the Administration are not the answer. By significantly increasing the up-front cash requirements imposed on FHA borrowers, the Administration's proposal will unnecessarily undermine the major benefit FHA affords would-be homeowners -- i.e., lower up-front cash requirements than the conventional market requires. The better approach is that proposed by Senator Cranston and Congressmen Vento and Ridge --to lower effective LTV ratios by lowering the high up-front insurance premium that is now required. In rejecting this "kinder and gentler" approach, the Administration is sacrificing homeownership affordability for budgetary gimmickry.

HIGH UP-FRONT CASH REQUIREMENTS ARE A MAJOR OBSTACLE TO HOMEOWNERSHIP

Between 1976 and 1988, studies show, homeownership rates among households between the ages of 30-34 declined in every region of the country. Indeed, during the eighties homeownership rates have

declined among all households below the age of 50. Similarly, the percent of first-time buyers among the total number of home purchasers declined during the eighties in every region of the country.

These figures reflect the fact that high home prices and interest rates have combined to create enormous obstacles to home ownership for first-time homebuyers. Without substantial funds from the sale of a previous home, new homeowners face substantial monthly payment obligations and hefty up-front costs.

For many renters, the biggest obstacle to homeownership is high monthly payments. They simply cannot meet the debt-to-income ratios required to qualify. But for a significant number of renters, the major obstacle to homeownership is the steep up-front cash required at closing. With high home prices, even a 5% downpayment translates into thousands of dollars.

Beyond the cash required to meet a downpayment, first-time homebuyers face increasingly sizeable closing costs. Origination fees, discount points, settlement charges, escrows and local transfer and other taxes can add up to thousands of dollars, making the transaction costs of homeownership particularly steep in many jurisdictions.

A 1986 study by the State of Maryland revealed the high range of closing costs associated with homeownership throughout the country. The State of Maryland asked each state to submit the closing costs on an $80,000 mortgage that would be required in the jurisdiction in the state with the highest closing costs. Of the states that responded, closing costs ranged from a low of 2.3% of the loan amount to a high of 8.3%. ($1,850 in North Dakota to $6,600 in Delaware.)

THE ADMINISTRATION'S PROPOSAL WILL UNNECESSARILY CREATE NEW OBSTACLES TO HOMEOWNERSHIP BY INCREASING THE UP-FRONT CASH REQUIRED OF FHA BORROWERS

Compared with the conventional mortgage market, the FHA program puts families into homeownership with less cash required at closing. Indeed, this is the major benefit of the program for borrowers. In crafting any proposal to lower the maximum LTV ratio permitted under FHA, Congress must strive to minimize any increase in the up-front cash required of FHA borrowers. Otherwise, we will be damaging the very heart of the program.

Although the up-front cash required of FHA borrowers is less than in the conventional market, the cash required is still significant. On a loan amount greater than $50,000, the current program requires a cash downpayment of 3% on the first $25,000, and 5% on the remainder. (This equals $4,500 on a $100,000 loan.) Borrowers are also required to pay pre-paid escrow amounts (taxes,

hazard insurance, etc.) in cash. On a $100,000 selling price, the total cash minimally required, assuming 1% pre-paid escrow) is approximately $5,650.

Under the current program, FHA borrowers are allowed to finance all closing costs beyond the pre-paid escrow costs. This substantially lightens the up-front cash burden borrowers would otherwise face.

The Administration's proposal, as described in Secretary Kemp's June 6 testimony before this subcommittee, will seriously undermine homeownership affordability under FHA by requiring borrowers to pay two-thirds of their closing costs in cash. This will add approximately $2,000 to the cash now required on a $100,000 home with 3% closing costs. (See attached table) It is likely to foreclose thousands of eligible borrowers from homeownership. The program modifications required under the Senate bill, which are different than those proposed by the Administration initially, will have similarly adverse affects by capping the maximum permissible LTV ratio, excluding MIP, at 97 or 98 percent.

Although a higher up-front cash requirement will produce lower LTV ratios than the current program allows, there is a better way to achieve that goal. Currently FHA borrowers are charged a lump-sum 3.8% insurance premium at closing. This amount can be financed now, and will remain financeable under both the changes proposed by the Administration and those incorporated into the Senate bill. Adding this substantial fee to the loan balance substantially increases the true LTV ratio. (The ratio produced by dividing the loan amount by the purchase price.) By lowering the up-front premium amount, and adopting a pay-as-you-go annual premium approach, the maximum true LTV ratio permissible under the current program will decline significantly, without increasing each borrower's up-front cash requirements.

This pay-as-you-go approach, combined with a cap on true LTV ratios permissible under the program, will achieve several beneficial results. **First**, it will lower the maximum permissible true LTV ratio relative to the current program and thus lower the risk to the fund. Indeed, combining this approach with an absolute cap on true LTV ratios of 100 percent, which Senator Cranston has proposed, will result in lower permissible LTV ratios than either the Administration's proposal or the Senate bill would allow. Indeed, the attached table shows that, because the Administration would retain the current 3.8% up-front premium, its proposal will produce true LTV ratios that exceed 100 percent. The same is true of the changes incorporated into the Senate bill.

Second, it will allow borrowers to finance most if not all of their closing costs.

Third, it will also promote the solvency goals of the program

by ensuring that the MMI fund will receive some amount of insurance premium on every FHA loan insured. According to Price Waterhouse, when the entire premium is totally financed up-front, as under the current program, "FHA effectively collects virtually none of the premium when a loan defaults." Price Waterhouse report at 41.

Fourth, for most borrowers, who finance their up-front premium, it will produce lower monthly payments than the Administration's proposal because it produces a lower loan amount. Although the Cranston proposal requires a slightly higher annual premium than the Administration's proposal, this higher cost is more than off-set by the lower monthly payments produced by the lower up-front premium.

The Administration and Congress must not subordinate the needs of first-time homebuyers to budgetary hocus-pocus. Over the short term, any reduction in the up-front premium in favor of a pay-as-you-go approach will show up as declining revenues to FHA. Of course, the annual premium will make up for this short-term effect over time. However, Congress must not sacrifice the needs of first-time homebuyers for the sake of budgetary hocus-pocus.

The federal deficit problem will not be solved by the smoke and mirrors involved in imposing hefty premiums that may never be recovered. The small improvement maintaining the current hefty up-front premium makes in the appearance of the federal budget is simply not worth the social costs it requires.

The Administration's Proposal To Adopt Risk-Based Premiums Is Not Good Public Policy and May Not Deter Against Adverse Selection

Since its inception, the FHA program has been based on the principal of cross-subsidization. That is, by imposing identical requirements on all FHA borrowers, lower-risk borrowers subsidize the higher costs to the fund of higher-risk borrowers. This approach maximizes the program's ability to help those with the greatest needs and thus promotes important social goals.

Its Administration has suggested that the risk-based insurance premium approach will help avoid adverse selection, or the tendency of lower-risk borrowers to select a conventional loan to get terms more favorable than those available through FHA. However, the Administration has not supplied any data to support its claim that the risk-based approach it has proposed will achieve this goal.

First, the Administration has not shown whether there is currently a significant pool of low-risk FHA borrowers (i.e., those with an LTV lower than 90%) who would qualify in the conventional market. If there is no such pool, there is no need to deter against adverse selection. If there is such a pool, we need to

discuss whether the federal government should be supplying a product to those who have the ability to purchase it through the private market.

Second, the Administration has not presented data on the insurance premiums low-risk borrowers are required to pay in the conventional market. The current 3.8% up-front premium may already be less attractive to low-risk borrowers than the premium required in the conventional market. If so, any low-risk borrowers that still opt for an FHA loan are not selecting FHA on the basis of the insurance costs involved and will not necessarily abandon FHA if these costs are changed.

In any case, the non-risk based premiums required under the Cranston approach are less costly for low-risk borrowers than the premiums required for the same class of borrowers under the Administration's proposal until the loan is into its 4th or 5th years. Since the typical residential mortgagor prepays within 7 years, the Administration's proposal may produce more adverse selection than the Cranston approach.

Congress Must Not Give HUD Unlimited Discretion to Modify the Program to Achieve the Necessary Capital Requirements, Which Should Be Established at 1.25%

We believe that Congress must monitor the program closely and legislate any changes that may be needed in the future to meet whatever capital goals are necessary. Unfortunately, however, the Senate bill gives HUD unlimited discretion to modify any aspect of the program to achieve the prescribed capital standards. In light of the insensitive and unreasonable proposals HUD has presented so far to achieve these standards, we are simply unwilling to give HUD such carte blanche authority in the future.

LOAN FINANCING ANALYSIS OF VARIOUS FHA OPTIONS

		CURRENT LAW	HUD PROPOSAL	VENTO/RIDGE (After phase in)
A.	Selling Price	100,000	100,000	100,000
B.	Financable Closing Costs*	3,000	1,000	3,000
C.	Acquisition Cost	103,000	101,000	103,000
D.	Downpayment (Cash for closing)	4,650	4,550 2,000	4,650
E.	Loan Amount Before MIP	98,350	96,450	98,350
F.	MIP	3,737	3,665	1,328
G.	Total Financed	102,087	100,115	99,678
H.	FHA LTV***	95.5	95.5	95.5
I.	True LTV****	102.1	100.1	99.7
J.	Initial Cash Required	4,650	6,550	4,650
K.	Additional Closing Costs**	1,000	1,000	1,000
L.	Up-Front Cash Required of Borrower	5,650	7,550	5,650

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* Assumes 3% total closing costs, excluding prepaid escrow.

** One point for prepaid escrow (currently cannot be financed). (Total closing costs of 4%)

*** Loan Amount Before MIP amount divided by Acquisition Cost (Line E divided by Line C)

**** Total Financed divided by Selling Price (Line G divided by Line A)

THOMAS CRAREN, PARTNER, OFFICE OF GOVERNMENT SERVICES, PRICE WATERHOUSE, WASHINGTON, DC

Mr. CRAREN. That proposal often has been characterized as another Price Waterhouse option. And if you read our report, we always said that under this option the premium is not financed. We never assumed that the 1.25 percent or 1.35 percent in our report, was financed.

Senator D'AMATO. In other words, you're putting the whole premium up front.

Mr. CRAREN. That's right.

Senator D'AMATO. Do you agree with that, Mr. Lasko?

Mr. LASKO. You're not putting the whole premium up. You're putting the premium in cash.

Senator D'AMATO. The 1.35 percent up front.

Mr. LASKO. If you get down to debating whether to finance or not, you can price that out.

Senator D'AMATO. Now, you know something, at one point you say, "Let's put up 1.35 percent." Up front, as opposed to financing 3.8 percent. And then when you say, "OK, let's put the 1.35 percent up front," you say, "Wait a minute. Let's talk about financing the 1.35 percent."

Isn't that what you just did to me?

Mr. LASKO. But financing——

Senator D'AMATO. In your argument, is that what you just did to me?

Mr. LASKO. Financing 1.35 percent is a lot safer than financing 3.8 percent.

Senator D'AMATO. You're not putting one darn penny up front more. What you're saying is lower the premium cost. That's all you're saying for the insurance.

Now I might not—you know, I might not—I couldn't maybe resist or maybe rebut the contention between 3.8 percent, although I don't have the analysis, financed over X number of years as opposed to 1.35 percent put up front. But what you do is you come in on one hand and you say 1.35 percent up front; that is better than 3.8 percent annualized.

Isn't that what you're saying? And then we say, "OK, let's do it." Then you back off and say, "No, let's finance the 1.35 percent because that's going to reduce the monthly cost and therefore the default ratio."

My gosh! What about the people who don't default? And those moneys are going into the fund now. The fund is—does not even get those moneys. You are going to reduce maybe the default ratio, but you are to put the fund in deeper jeopardy. It's going to get less in the way of premiums paid to it, less money flowing into it.

Now isn't that a fact? Yes or no?

Mr. LASKO. Senator, if that's wrong——

Senator D'AMATO. No.

Mr. LASKO. That's not a fact.

Senator D'AMATO. Then let me ask you something. If I'm wrong, I really want you to explain it to me.

Mr. FLYNN. The money goes into the fund, Senator, when the Treasury pays it back over the term when the actual books of busi-

ness come due on it. What happens is that the premiums come into the Treasury, and it is scored for budgetary purposes and financed in that mortgage and then paid back to it, and it is also paid back if there is default.

So it is lost to the Treasury and lost to the fund.

Senator D'AMATO. Mr. Flynn, if you are telling me that by reducing the premium on the FHA, which in essence is what I'm hearing, from 3.8 percent to 1.35 percent, it is going to make the FHA sounder, I have great difficulty accepting that concept.

Mr. FLYNN. Let me take your own logic, then. Senator, in your own opening comments, you said the real major problem is that 1 out of 5 that overly finance their properties go into default. When you collect a 3.8 percent of premium that was to have been earned in the future up front and finance it, that is what drives you over the 100 percent mortgage. You put 3 percent down, and then you add 3.8 percent to the mortgage——

Senator D'AMATO. I have no problem with that. I have no problem with saying, "Then let's put up,"—if you say 1.35 percent—"up front." Look, I'm not for financing it over the life of it. I want to get more up-front money.

So, if you are saying to me, why don't you reduce the premium and put the cash up front, terrific! Price Waterhouse, what do you say?

JAMES WADDELL, PARTNER, OFFICE OF GOVERNMENT SERVICES, PRICE WATERHOUSE, WASHINGTON DC

Mr. WADDELL. I think there is some misunderstanding. In our analysis, our projection of defaults, the financed mortgage insurance premium has very little to do with the loan-to-value ratio because it can be refunded. And, in a sense, it is both a liability of the borrower and an asset to the borrower.

So by changing somehow whether you are financing 1.35 percent or 3.8 percent, you're really not having a material effect on the loan-to-value ratio of the borrower in the way that it has been characterized.

KENNETH D. SEATON, CHAIRMAN AND CEO, D&N SAVINGS BANK, HANCOCK, MI

Mr. SEATON. I think the key to the Price Waterhouse study and the key for the conventional lenders is that people who put cash into the home are the ones that keep the homes. By reducing the premium and then financing it, you are making it easier to buy, instead of having people put more money into the property.

[The complete prepared statement of Kenneth D. Seaton follows:]

STATEMENT OF KENNETH D. SEATON

CHIEF EXECUTIVE OFFICER OF

D & N SAVINGS BANK, HANCOCK, MICHIGAN

ON BEHALF OF THE

UNITED STATES LEAGUE OF SAVINGS INSTITUTIONS*

BEFORE THE

SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

OF THE

UNITED STATES SENATE

July 24, 1990

*The United States League of Savings Institutions serves more than 2,500 member institutions. The principal officers include: Kenneth D. Seaton, Chairman, Hancock, Michigan; Robert B. O'Brien, Jr., Vice Chairman, Morristown, New Jersey; Fred Webber, President, Washington, D.C.; and J. Denis O'Toole, Executive Vice President for Governmental Affairs. League offices are at 1709 New York Ave. N.W., Washington, D.C. 20006 (telephone 202-637-8900) and 111 East Wacker Drive, Chicago, Illinois 60601 (telephone 312-644-3100).

Mr. Chairman and members of the Subcommittee, my name is Kenneth D. Seaton and I am the Chairman and CEO of D & N Savings Bank of Hancock, Michigan. I am pleased to appear here today in my capacity as Chairman of the United States League of Savings Institutions. The U.S. League represents 2,500 savings institutions which are committed to home lending. Our members remain committed to their role as housing lenders, not only as a result of the 70 percent Qualified Thrift Lender Test, but as a practical business decision. The U.S. League and its members appreciate your invitation to participate in the Subcommittee's deliberations on the subject of restoring the financial health of the Mutual Mortgage Insurance Fund (MMIF).

Before addressing the specific issues of today's hearing, Mr. Chairman, I want to extend to you and to Senator D'Amato the congratulations and admiration of the U.S. League for your leadership in guiding S. 566 through the Senate. We are well aware of the years of work that went into this effort by both of you and your staffs. We sincerely hope that there will be a major housing bill enacted into law this year and that it will, essentially be S. 566. For the past decade housing has been slipping in terms of public policy priorities. It is our hope that the enactment of a housing bill this year will mark the end of

this trend and the start of a new, upward trend in terms of attention to the housing needs of the nation.

SUPPORT FOR SENATE AMENDMENTS TO FHA

I want to begin my comments on the FHA reforms by expressing the strong support of the U.S. League for the actions taken by the Senate in S. 566 to restore the MMIF to a sound financial condition. In adopting the FHA package of amendments, the Senate has responded in a constructive and measured way to the recent loss experience of the MMIF which, if not corrected, will cause the fund to be insolvent and become a direct cost to the taxpayers. The U.S. League supports and applauds the Senate's actions because the League continues to support the FHA single family home loan program as a vital part of the fabric of federal housing policy. The original purpose for the program -- to provide home ownership opportunity for families of modest means -- is no less important today than it was fifty years ago.

Virtually every housing affordability study that is published points to the fact that the opportunity for the first-time buyer in the middle-income range is diminishing, not improving. Given that the need for the FHA program will likely continue in the foreseeable future, it is of the utmost importance that Congress address the FHA reform issue now and address it in a comprehensive manner. For this reason, we applaud the actions taken by the Senate in making

the Cranston-D'Amato FHA package a part of the National Affordable Housing Act (S. 566).

The Senate bill makes significant changes in the FHA loan standards. The down payment rules are tightened to ensure that there will be at least some, minimal, owner equity in homes securing FHA loans. Also, a new premium structure is put in place which will rebuild the MMIF reserves and, at the same time, reward those FHA borrowers who represent the least risk to the MMIF.

The urgency of taking up the FHA issue was made clear by the recent Price Waterhouse study of the insurance fund. The study found that, while the fund is solvent for the moment, it is losing money and will not remain solvent if current policies continue. Fortunately, the study was done before the financial strain on the fund reached a crisis point. If the Congress acts this year on the reforms recommended by the Administration, a crisis can be avoided, and there should be a reasonable assurance of a healthy and viable FHA mortgage program for future generations of Americans.

HOUSING VALUE ASSUMPTIONS

It must be emphasized that the Price Waterhouse FHA reform proposal assumes that home prices will appreciate at a rate of 3.25 percent annually for the next several years. It is a debatable issue whether such an assumption should be made at this time. Should Congress wish to plan for slower

growth in home prices, it should not only adopt the FHA provisions of S. 566 but take additional steps to build the insurance reserve to higher levels and at a faster pace than suggested in the Price Waterhouse study.

A study released last week by the Joint Center For Housing Studies suggests that there will be relative stability in home prices for the decade ahead. The study offers better news for home owners and for managers of the MMIF than projections from other sources who predict a decline in home values in the coming years. It is not clear, however, that price stability will satisfy the test put forth in the Price Waterhouse report. The stability predicted by the Joint Center may fall short of the 3.25 percent appreciation assumed by Price Waterhouse. The U.S. League's independent analysis generally supports the findings of the Joint Center For Housing Studies. This forecast suggests that Congress should, at the very least, adopt the FHA amendments but also remain vigilant to the possible need for additional measures in the years ahead.

An added caution is in order here. While many of the goods and services produced in our economy can be analyzed on a national and even global scale, housing remains essentially a local phenomenon. Trends in home prices can be very deceptive if looked at only in national aggregates. This is of critical importance for today's hearing. The losses experienced by the MMIF were not caused by a nationwide decline in home values but by very severe

declines in values in specific, local housing markets. This very vivid recent experience should serve as a caution to the Congress and the Administration not to be overly confident of national price trends, but to look closely at the trends in local and regional markets and the degree of exposure of the MMIF in the markets which are vulnerable to adverse trends. This point was well-illustrated by the report last week that Washington, D.C., one of the strongest housing markets in the nation, actually experienced a slight DECLINE in home prices.

EQUITY IS THE KEY TO RISK

The Price Waterhouse study points out that the MMIF has been losing money in recent years due to the large percentage of defaulted FHA loans where the borrowers had little or no equity in the home. Our experience in the conventional loan arena would have suggested that this would be the case. Consistently over the years, mortgage delinquency and foreclosure figures have been inversely proportionate to the down payment or equity in the property. It is for this reason that conventional lenders regularly require private mortgage insurance for any single family home loan where the loan-to-value (LTV) ratio is more than 80 percent. As a general rule, private mortgage insurance is not available for a LTV of more than 95 percent. It is not uncommon for conventional portfolio lenders to self-impose a LTV ratio limit of 90 percent and still require

mortgage insurance. To do otherwise -- i. e., to make loans using the FHA polices of the past few years -- would be an unsafe and unsound practice for any federally regulated financial institution.

The Congress is confronted with a dilemma. On one hand, low down payments are the principal attraction of the FHA program. Studies of housing affordability suggest that it is the down payment hurdle and not the monthly payments that prevents families from purchasing that first home. On the other hand, as the Price Waterhouse study makes abundantly clear, it is this very feature of the FHA loan program that has put the MMIF at risk. Congress could, of course, require that FHA borrowers meet the same standards as borrowers in the private market. Such a policy would protect the MMIF, but would negate the purpose for having an FHA loan program.

Somehow Congress must find a balance between two competing objectives: 1) keeping the entry cost for home buyers low enough to be helpful, and 2) keeping the MMIF financially sound and self-supporting. How is Congress to know where that "perfect balance" is? What is called for is a "best judgment" call this year in the context of the pending legislation, followed by constant monitoring of the program and a willingness to move the balance point in either direction as experience dictates. One thing is clear. The present policies cannot continue without significant risk to the MMIF and the self-sufficiency of the

FHA loan program. Somewhere between the present FHA standards and the conventional market standards is the balance point Congress must find. We submit that the Administration's proposed FHA changes, as adopted by the Senate in S. 566, strikes the appropriate balance and should be enacted into law this year.

There are those who would argue that the FHA reforms in S. 566 go too far in the direction of the conventional market. It has been suggested that the reforms adopted by the Senate will preclude a large number of families from qualifying for an FHA loan. Obviously, any tightening of standards will mean that some people are no longer qualified and, conversely, a loosening of standards will mean that more people will qualify. The exact number, in either direction, is guesswork at best. Even the current FHA standards, permissive as they are, exclude thousands of families who desire home ownership. The important question is what standards will produce an acceptable level of risk for the insurance fund, not how many families are excluded by any particular standard.

While the FHA standards adopted by the Senate are tougher than present FHA standards, these standard are still much more lenient than the conventional market standards. The conventional mortgage insurance will still be more costly for comparable coverage, the ability to finance the premium as part of the loan will be more restricted, and the

minimum down payment will remain significantly higher than the FHA will allow, even with the Senate amendments.

The proposition that the Senate "went too far" in toughening the FHA standards is a hard one to sustain in light of the fact that the legislation calls for only two or three percent equity compared to the conventional market's five percent. To the best of our knowledge, private mortgage insurance is simply not available at any price for a LTV greater than 95 per cent. By this measure, one could argue that the Senate amendments still leave the MMIF at an unacceptable level of risk. While that is a judgmental conclusion, one thing is clear. The FHA loans made under the Senate bill standards will still be loans that the conventional market would not make because they would represent unacceptable risks to the conventional mortgage market.

OTHER FEDERAL PROGRAMS FOR AFFORDABLE HOUSING

It should be noted that the FHA mortgage program is not the only federal program aimed at helping low and moderate income families become home owners. The mortgage revenue bond program is specifically targeted to first-time buyers of median income and below. In addition, there is now in place an affordable housing program in each of the twelve Federal Home Loan Banks as a result of the FIRREA legislation enacted last year. Through its Housing Opportunities Foundation, the U.S. League has promoted this

program to League members. We are very pleased by the fact that in the first round of funding the program was over-subscribed. The level of interest by our members and community groups has exceeded everyone's expectations.

We offer these observations here only to make the point that when evaluating the impact of changes in the FHA standards and who is qualified or disqualified, we should not assume that the entire burden of the federal effort for affordable home ownership rests with the FHA single family program.

MORTGAGE LIMITS

S. 566, as adopted by the Senate, would continue the current mortgage limits for high cost areas for two years. The $124,875 ceiling was adopted less than one year ago by the Congress as part of the HUD/Independent Agencies Appropriations Act. In our view, this action was not justified by any marketplace developments since the previous limit had been in effect for such a short time. Therefore, we certainly think that it is appropriate to hold the line on this matter for the time being.

The U.S. League agrees with the conclusion of the Administration that the current ceiling already brings the FHA mortgage loan program into income levels and housing price levels which are above what can reasonably be called modest or moderate. In the case of the trade-up market, an FHA mortgage of $124,875, combined with equity transferred

from the sale of the previous home, can finance the purchase of a home approaching the $200,000 price range. Debates and testimony about this issue frequently assume that the first-time buyer is the only user of the FHA program. That is simply not the case. There is no limit, or disincentive, in the law to using the FHA program over and over again as one trades up the housing price ladder. To our knowledge, Congress has never considered putting any limit on the number of times that a home buyer can use the FHA program. Other housing assistance programs, such as the mortgage revenue bonds, do target the assistance provided to first-time buyers. This has never been the case with FHA loans.

Mr. Chairman, the U.S. League continues to hope that the Congress will re-examine the utility of the mortgage limit concept. We believe that as a means of targeting the assistance implicit in the FHA single family loan program, the mortgage limit is, at best, an imperfect tool. Obviously, the kind of examination required cannot take place between now and the end of this Congress. There is time, however, to conference the two bills and send a housing bill to the President before adjournment. The U.S. League wants very much to see that happen. Therefore, we support the action taken by the Senate in holding the current ceiling in place for a limited time rather than making it permanent. We respectfully urge, Mr. Chairman, that the Subcommittee allocate sufficient time next year for an examination of the efficacy of the mortgage limit device

and a thorough exploration of alternative targeting devices such as income standards.

CONCLUSION

Again, Mr. Chairman, I want to express our appreciation to you and to Senator D'Amato for all the time and effort to get S. 566 adopted by the Senate. We strongly support the legislation which the Senate has passed and look forward to its eventual enactment this year. In our view, the FHA reforms in S. 566 strike a reasonable balance between the need to help people of moderate income become home owners and the absolute necessity of restoring the financial integrity of the Mutual Mortgage Insurance Fund.

Senator D'AMATO. I would like you to respond again, Mr. Lasko, to what Mr. Seaton observed and what I attempted to articulate, but he did in a much, much more concise manner, because he's not a politician.

Either you or Mr. Flynn. Did you hear what Mr. Seaton said?

Mr. LASKO. Yes, we agree that the amount of real investment that the homeowner has, has real cash in, is what is going to motivate them, particularly if house prices are not growing as rapidly as they—that is the major motivation to make your mortgage payments to stay in the house.

We believe, and in this case, we frankly don't quite agree with the Price Waterhouse and the economists' arguments that when you take a 3.8 percent premium, pay it up front and finance it, that the typical home buyer really views that as equity. This is a judgment call.

I don't think the typical home buyer, when they go to closing and all of these things are going past them, they hardly notice that 3.8 percent because it is in the mortgage. They are not taking it out of their pocket. I don't think the typical home buyer views that as equity in his house.

Senator D'AMATO. Correct. Let me suggest this: is Price Waterhouse saying that if you put up—in your report--because everybody seems to have this, and you think that there is some ambiguity and that's why you've taken the point to explain it—are you contending in your report, if you put up 1.35 percent as opposed to the 3.87 percent, which is financed in the manner that it is, the 1.35 percent put up front, does that equalize out to the 3.8 percent to Treasury for purposes of insurance, et cetera.

Mr. CRAREN. In the option we model in our report, again, we said it was not financed. We assumed that the money was going to be paid in.

Senator D'AMATO. Let me go to Mr. Lasko. Mr. Lasko, would you support a 1.35 percent premium that was paid up front as opposed to the provision as it now stands in the Senate bill, which is 3.8 percent, which is financed over the life of the mortgage?

Mr. LASKO. I would strongly support the lower, the 1.35 percent up front as opposed to the 3.8 percent, if that is your question.

Senator D'AMATO. OK, what Price Waterhouse impact does that have actuarially on the soundness of the FHA fund? You or Mr. Weicher, have you done that analysis? You've used these figures.

Mr. WEICHER. Yes.

Mr. WADDELL. I think the proposal that is advanced now, and I am referring now to the Vento-Ridge proposal in the House——

Senator D'AMATO. I'm not talking about Vento-Ridge. I don't know if they're talking about 1.5 percent up front.

GREGORY T. BARMORE, PRESIDENT, MORTGAGE INSURANCE CORPORATION OF AMERICA, WASHINGTON, DC

Mr. BARMORE. Representing the mortgage insurance companies. We are in this business. Mr. Lasko's point about putting 1.35 percent up front—I think that's what you said——

Mr. WADDELL. No.

Senator D'AMATO. He started with cash and then he said, "Let's finance that." But when we finally came——

Mr. BARMORE. If you were to do that and put 1.35 percent up front as cash, the other change that you would have to make in the administration's proposal is in the stream of renewal premiums to get the equivalent economic well-being for the fund.

Senator D'AMATO. Mr. Barmore, would you explain that to the uninformed layman like myself as to exactly what you are talking about?

Mr. BARMORE. Right now, for example, you have the additional risk-based premium, I think, as you call it. Fifty basis points for a given number of years, and it relates to different risks depending on real downpayments. And, in fact, if you're going to get less money up front, there is a big difference between 3.80 percent and 1.35 percent.

Senator D'AMATO. You would get more money up front, actual cash. You would get the 1.35 percent nonrefundable.

Mr. BARMORE. We get more cash from the borrower, but the FHA doesn't receive more cash.

Senator D'AMATO. OK.

Mr. BARMORE. Under 3.80 percent the 3.80 percent is in the mortgage. Somebody writes a check to the FHA——

Senator D'AMATO. Kabish, yes.

Mr. BARMORE. If you're going to have the big difference, then what you've got to have is a more substantial renewal premium for a longer period of time.

Senator D'AMATO. A more substantial renewal premium.

Mr. BARMORE. Fifty basis points for 4 years doesn't cut it. Fifty basis points for a much longer period of time.

Mr. WEICHER. It is 50 basis points for 30 years.

Senator D'AMATO. The mortgage premium, could you tell us about what that would be? Then I would like to find out from Mr. Lasko——

Mr. BARMORE. Somewhere in the 65 basis points range or something like that.

Senator D'AMATO. Mr. Lasko, you will understand this stuff inside and out; right? You do?

Mr. LASKO. I think I understand quite a bit, yes.

Senator D'AMATO. So what Mr. Barmore is saying is that to make up for that loss of the 3.87 percent, if you only put up 1.35 percent in actual cash that came from the mortgagee, from the borrower, that we would have to have a renewal premium of about .65 percent or whatever actuarially it works out. Instead of for 4 years, you were saying, which is the present program, see him getting an education—for 30 years.

Mr. BARMORE. If you do that, you have a premium structure that starts looking an awful lot like the private sector.

Senator D'AMATO. Whatever it works out to—somebody says 40 basis points.

Mr. LASKO. Whatever you need.

Senator D'AMATO. Whatever it should take, we're not going to attempt—but let me ask you this, Mr. Lasko. What is your feeling then?

Mr. LASKO. I support that. I believe——

Senator D'AMATO. You would support that.

Mr. LASKO. I support the idea of an annual premium as the preferred way, as opposed to an up-front premium.

Senator D'AMATO. And what about the 1.35 percent in cash, the premium that they're going to pay, that they are required that they cannot finance?

Mr. LASKO. I believe to get the people into homes that we're aiming at that you have to finance it.

Senator D'AMATO. You see, now you really want your cake and to eat it.

Mr. LASKO. I think that is far better than the Senate bill which requires 3.8 percent up-front financed.

Senator D'AMATO. What about 1.35 percent not financed? Don't you want to deal—what about dealing with the central problem which says the default ratios take place because people don't have sufficient equity. Don't you want to deal with that? You don't want to deal with that, do you?

Mr. LASKO. I want to deal with it in a way that preserves the program for the people for whom it is intended.

Senator D'AMATO. Tell me how you do that? I want to know where you have suggested putting one penny extra up front?

Mr. FLYNN. In fact, we don't. We recommend the Vento/Ridge proposal that does not call for any more money up front. When you increase by $1200 to $1400 the downpayment under the Senate proposal, then we contend that fewer people are going to use the program.

I would recommend to you that a lot of people would not use the program when there is that extra kind of money. And when they don't use the program, the kinds of number that they're suggesting they're going to earn to become actuarially sound will not happen. And the adverse selection will be people, when you require that kind of downpayment, then the better risk borrowers are going to be going to the private mortage sector than to FHA.

And by passing the Senate proposal, if it goes in its current state, you will be sounding the death knell to FHA, and that's what we don't want to have happen. We want an actuarially sound program, and we want one that will work and stay there and function. But we don't want one that will take the people that the program was designed to serve out of the game.

Senator D'AMATO. We are playing hardball now, so let's play it. And how do you lower the default rates without requiring more money up front? What you were saying now—and I am not suggesting for one second that you may not be right as it relates to the insurance in requiring 1.35 percent up front and then the stream of revenues over 30 years as opposed years; I'm not going to argue that; I will accept that point.

But what have we done? Do you reject—let me ask you this? Do you reject—do you reject the contention that Price Waterhouse and others and that the HUD people have said that in order to reduce the default rate, we've got to require more cash up front? Do you reject that?

Mr. FLYNN. I believe the one thing they don't have in that study is taking into account what happens when you increase the down-

payment. That takes people out of the game. And, therefore, you are no longer a player.

Senator D'AMATO. Therefore, you should not reform the program? If anybody is going to be taken out because they might be required to put more money in, you would say, "Continue business as usual?"

Mr. FLYNN. We believe that increasing the monthly payment will take some people out of the game, but it will be far fewer people. The people that can least afford it will not be taken out if, in fact, you maintain the downpayment as it is now structured.

They are not coming to the table without any cash at all, Senator. The people seeking an average mortgage are coming to the table with $4,000 to $5,000 in cash, and for someone that's only earning $25,000 a year, that's a lot of money.

Senator D'AMATO. Yes, but Mr. Flynn, that's not the guy that's defaulting. You know that. And the studies indicate it. The guy who's defaulting is the guy who isn't coming up with any money. And you're not doing—and the proposals that I've heard put forth——

Mr. FLYNN. Not coming up with any money?

Senator D'AMATO. You're not increasing any more money of equity that the people who are defaulting now at unacceptably high rates would be required to deal with.

Mr. FLYNN. When you collect 3.8 percent of the premium——

Senator D'AMATO. I gave you for argument's sake that we would deal with that situation on 3.5 percent cash up front and finance the rest. Now that's 1.35 percent.

Mr. FLYNN. I will accept that as a commitment.

Senator D'AMATO. In cash.

Senator CRANSTON. Mr. Hendershott.

Mr. HENDERSHOTT. I would like to say that the actuarial soundness of the fund doesn't depend solely on the default rate. You can keep the default rates exactly as they are today and as long as you are collecting more money, the fund can be sound. You don't have to lower the default rate in order to make the fund sound.

Mr. BARMORE. The default rates of the 1980's are running 13 to 20 percent. If you raised the premium necessary to pay for those kinds of losses, nobody will be able to afford the program. You cannot have one out of four houses going down and have an affordable premium.

GAIL CINCOTTA, EXECUTIVE DIRECTOR, NATIONAL PEOPLES ACTION, CHICAGO, IL

Ms. CINCOTTA. I think you are all talking about how much money we have to put in the insurance fund to pay off all of the defaults that we're going to have, regardless of what we do. I think what you have ignored is the human factor and the other side of what if we don't have any defaults. Then we don't have a depleted insurance fund. Either way, if you keep the people in the homes, you don't have the kind of default that you have to pay for.

To get this price increase out, I would go for the 1.35 paid for up front. And that would be one part of the hope and the help.

When FHA had defaults in the 1970's, the way it was cured was not necessarily through the insurance premium. But there were Justice Department indictments—mortgage bankers, realtors, builders, city officials, et cetera.

There was legislation 518 (b) and (d) that helped the homeowners pay for problems in their homes after they bought them.

There was the assignment program that kept people, if they had a problem with illness or loss of job, in their home.

And there was the repair and sell program. All of those were dropped. And the other thing that happened, in a few years, the direct endorsement came in, where mortgage bankers could directly endorse the mortgages.

There was a cut-back in HUD's staff. And there was a whole series of things that happened, and that more and more people were buying homes higher and higher and higher than their home was worth, with mortgages higher.

Part of that was also the discriminatory points that are charged on homes under $40,000 to $60,000, on, say, $60,000 down. And I think that, even that one piece, and I know you're going to deal with it in conference because it's coming through the House, that they could not charge discriminatory points, which also get folded in to make the mortgage higher.

That would stop a lot of the defaults. So I think that we have to look at it two ways.

One of how do you make the insurance premium such and pay for it that there is more money and, therefore, claims, but really our goal should be not that we paid out $5 billion in claims, which is bad—we did it again this year, in 1989—but how many people lost their homes?

That what FHA should be about is not only making sure you're actuarially sound but the people that you're supposed to help stay in those homes.

Last year or so we debated should the cap go off. And in the process of debating should the cap go up or down off the FHA mortgages, nobody dealt with the clean-up.

The last figures that—we were dealing with 1988 figures now. Now we have 1989 figures and it's almost 91,000 families—what's that?—364,000 people's lives, plus our neighborhoods were affected by all of us dealing with fighting over the cap as opposed to really cleaning up how FHA operates, how it can operate for the people.

And I hear that missing in this, if we could decide on how you pay for it, how it gets paid up front, that nobody should go in with I think less than 97 LTB, but for sure not more than 100 loan to value, but really can we deal also with the clean-up and what it would take to keep the people in their homes so we don't come back in a year and fight over 90,000 claims, which is another $5 billion. But, forget again, 90,000 families, which I think is the crux of it.

Senator D'AMATO. I think you're right. The human factor is a fact which is not told clearly when you just hear about default ratios. And so, while we talk about loss to taxpayers, I had that one picture put up there of the poor family—it's thrown out.

I just think we're crushing them. And I have to tell you something. When we fool around with these statistics this way, and I'm

not suggesting I know the answers, but I know what we're doing. And the continuation with just slight modification is not fair and it's not right. Not to the taxpayer, not to that homeowner who we're trapping in there, who has not developed the kind of ability to save the husband's resources and to have the training to go in.

Let me tell you, we've seen all these estimates on how many families would be precluded on annual basis from the FHA program. Now, the realtors estimate 100,000 families would be shut out from the FHA single-family mortgage.

The mortgage bankers estimate 1.1 million—Price Waterhouse estimates 15,000–35,000 families would have to wait. In other words, before the husband did enough resources for that downpayment.

I am intrigued as to the disparity between one figure that says 15,000–35,000 would be delayed or would be precluded, and the figure that the mortgage bankers gives, which is 1.1 million as distinguished from the figures which the realtors give, which is 100,000. And I'm going to ask Price Waterhouse and then any others if they would comment on that.

Mr. WEICHER. Senator, if I may comment on that, because the 15,000–35,000 figure is not a Price Waterhouse figure. It is a figure that we at HUD have estimated from our own analysis of the people with whom we do business.

Price Waterhouse was not asked to do that kind of work in the analysis. However, I might say we have asked Price Waterhouse to look at what the position of the Fund would be if, in fact, we lost the 5 percent of the business, which is about 35,000 mortgages, or if we lost the 15 percent of the business that the realtors have referred to.

And we find that a loss of either magnitude does not really—in business of either magnitude—does not really affect the overall well-being of the Fund. We are not happy to see people unable to buy homes.

We're equally unhappy——

Senator D'AMATO. Or delayed.

Mr. WEICHER. Pardon me?

Senator D'AMATO. Or delayed.

Mr. WEICHER. Or delayed. We're not happy to have that in either case. But, the position of the Fund in the proposal adopted by the Senate will not really be materially affected if there is a loss of the 5 percent, or if there is a loss of the 15 percent; whereas, under the Vento-Ridge proposal, if there is a loss of 5 percent or 15 percent, the Fund will build capital a bit more slowly, noticeably a bit more slowly across the period of a number of years.

Mr. SEATON. I think, Senator, if you would look at what's being developed, that the quality of business coming in really should be a concern. And if this were a corporate world, that 5 percent or so that were not able to qualify would be those that had been foreclosed on and been removed from their homes.

So you're not necessarily doing the people a disservice by raising the standards.

Senator D'AMATO. And delaying their coming in so that they have sufficient capital, so that they have reduced the chance of there being a foreclosure.

I mean, I see you want to say something.

Ms. MEIER. Yes. By way of introduction, I'm Michelle Meier. I'm with Consumers Union.

To a large extent in your opening statement, I think you characterize this as a battle between yourself and the industry. There is a substantial interest, I think, among consumer organizations and low- and moderate-income housing organizations in what's going on here. And there has been an endorsement by these groups of the Vento-Ridge proposal in the House and the Cranston approach here.

And I'm actually very concerned that your proposal and the administration's proposal, which are promoted as a way to achieve actuarial soundness, are also being couched as a proposal to protect first-time home buyers against foreclosure.

Senator D'AMATO. If I might just at that point say to you I have not indicated that I believe this is going to promote actuarially sound funding. I don't believe it will.

Ms. MEIER. OK. Well, I do think though that——

Senator D'AMATO. I actually don't believe that it will do that. I think there's going to be an infusion of dollars some place along the way to make up for past problems and that we should not just simply continue to build this incredible—I think Ms. Cincotta knows what's happening. This thing. And she's touched on a number of very real areas. And it seems to me consumer groups should be coming in and saying:

How do we crack down on the 1 or 2 percent of the unscrupulous, who just go out to inflate the prices, who push people through, who don't give a darn? Because they are the ones who, I think in many cases, and we haven't had the study—we asked the GAO to look in on this, take a look and analyze where the losses are coming from. We asked HUD to do that. I understand they're doing that.

But, I have to tell you I do not believe that we are going to achieve the kind of soundness actuarially that we would like to.

But I also believe, and I know you have a constituency and you represent them with the fullest degree of your ability, and I just suggest to you that you take a look at if we put people in the position where they're not going to be able to make those payments, where they're in a no-win, where 1 out of 5 of them are going to go down, is that beneficial to them?

Or do we want to attempt to deal with it to make housing, the most housing opportunities available in the soundest manner possible? Without precluding realistic opportunity? But where there is an opportunity of them making it. And I think that's the balance we seek.

That's the balance which this Senator seeks anyway.

Ms. MEIER. Well, I think how you do it is by not foreclosing homeownership to begin with. If there are counseling efforts and enforcement of underwriting standards, which I don't think we have seen during the 1980's, it's possible to still have home buyers in the program at a 100 percent LTV and have a much lower default ratio than we saw during the 1980's.

I think the 1 to 4 figures that you're citing do not separate out from those that went into default, those that wouldn't have gone

into default if the appraisals were done correctly, if there had been counseling and if there had been correct underwriting.

Price Waterhouse didn't go into that. So, let's not sort of disguise what we're doing here as a way to protect first-time home buyers from default when really what we're doing is preventing them from the major benefit of the program to begin with, which is getting them into houses.

Senator CRANSTON. May I ask Price Waterhouse to respond on two points? First, any comments you have on Senator D'Amato's feelings that your analysis was overoptimistic in view of declining home prices in many markets?

And, second, do you have any suggestions as to ways in which we can maintain an actuarially sound, or achieve an actuarially sound FHA while minimizing the people that will be excluded because of the up front costs?

Mr. CRAREN. Well, Mr. Weicher said it correctly earlier. We haven't had a chance to see the down-turn in real estate values come up. One thing inherent in our study is it's not—we say it's not frozen. If you see bad conditions developing, you should react to them. You shouldn't just allow them to happen and assume the structure that's been established will be fine.

It may well be that the economy is entering a recession, for example, and I guess, in that sense, we would be a little overoptimistic, although we tried to design the option so it would cover a Post-World War II recession.

The second point I think we tried to address throughout the study is to design something that accomplished what you said, Mr. Chairman. We tried to do it and make it sound, yet try not to design options in such a way to impair the usefulness of the Fund.

And I think that's the foundation of all the options we set out. We didn't take a stand on any specific option because we wanted a debate of this nature to look at the merits of each. And I think that was our intent in the study.

Senator CRANSTON. There are a few of you that haven't yet commented at all. Do the people that have not yet been recognized have any desire to—yes, Mr. Clay, and Mr. Robinson, before we go back to Mr. Hendershott. Y[illegible]

FRANK CLAY, FIRST VICE PRESIDENT OF THE NATIONAL ASSOCIATION OF REAL ESTATE BROKERS, LOUISVILLE, KY

Mr. CLAY. Thank you, Senator. My name is Frank Clay. I'm from Louisville, KY. I am a real estate broker, 1st vice president of the National Association of Real Estate Brokers. We're known as realtists.

Most of our members service the inner cities of this country. We've been selling properties to people whose only opportunities to buy have been through the FHA program. Prior to FHA, purchase money mortgages, loans from black insurance companies, or rent with options to buy.

So we have been involved in helping inner-city folks to become homeowners.

The increase in up front costs obviously is going to affect our clientele. Several studies, the Rouse—the Maxwell Study—indicated that more people—up front cost is a barrier to homeownership.

FHA insurance is very, very important to us. We want it to be a viable, strong, stable insurance plan. I noted that, in the Price Waterhouse statement, that it indicated that the reason that the program is as well off as it is today is because of the position it was in before the 1980's.

As a suggestion, I remember the way the premium was paid. One half of 1 percent was built into the loan. If that worked in the period before the 1980's, before the change, a suggestion is to go back to that way of doing the business, to return to the method that stabilized and created the large equity position that the program had prior to the change that was incurred after 1982 or 1984. I don't remember what year.

But, that's the position that our organization takes.

Senator CRANSTON. Thank you very much.

Mr. Robinson.

DWIGHT ROBINSON, DEPUTY DIRECTOR, MICHIGAN STATE HOUSING DEVELOPMENT AUTHORITY, LANSING, MI

Mr. ROBINSON. Thank you, Mr. Chairman. I represent the National Council of State Housing Authorities—State Housing Finance Agency. Excuse me.

I come from the State of Michigan where we participated through MRB's in the financing of single-family housing opportunities for low and moderate income people.

I should say that we think that the entire bulk of the discussion this morning has been with regard to the financial stability of the FHA, and we certainly support a strong and viable FHA.

I think, however, that the discussion that's only occurred toward the end of the session here or toward—from Ms. Meier—really gets to the point. If you preclude people from participating in the program by having higher barriers to entry in the name of maintaining the program, then you've gone a long ways toward reducing your effectiveness in meeting the goal that you set out to meet.

And that is to provide homeownership for low and moderate income people. Certainly, I agree with Mr. Clay that FHA opportunities with low or no downpayment requirements in inner-city areas of our country are the exclusive way that people have an opportunity to participate in the American Dream.

I believe that we can make financial changes to create and maintain a stable FHA. However, we should look at a gradual implementation of additional premium.

Beyond that, we think that we should stress some of the changes that were implemented only last year, which had to do with monitoring and prosecution of those endorsers who have not been doing the right thing in terms of what they should do.

Beyond that, I think that home counseling as part of the opportunity for someone participating in the program is a big step, a major step toward where we ought to go with the FHA.

I have a long statement and you have my written statement. I would echo again what Mr. Clay and Ms. Meier said in terms of the overall direction we think this discussion ought to take.

Thank you.

Senator CRANSTON. Mr. Hendershott.

Thank you.

PATRICK HENDERSHOTT, PROFESSOR OF FINANCE AND PUBLIC POLICY, OHIO STATE UNIVERSITY, COLUMBUS, OH

Mr. HENDERSHOTT. Thank you, Senator. I am extremely disappointed that Senator D'Amato has left the room. It's a lot more fun when he's in the room.

I'd like to particularly address your question regarding whether or not Price Waterhouse was too pessimistic and, in effect, whether Senator D'Amato was right that we are going to have a house price depression. This is a fundamental issue.

Let me just assume for the moment that Price Waterhouse is right that house prices are not going to do well, but they're not going to do very badly. Under this assumption, the Senate bill goes far beyond solvency called for by Price Waterhouse.

What the Senate bill is saying is that we're going to make new home buyers pay for the bad loans made in the 1980's. We're going to make new home buyers build equity for the old business.

Now, when we had the deposit insurance problems, we did not say we're going to make new depositors pay to keep old depositors whole.

When we had the farmers' loan problem, we did not say we're going to make new farm borrowers pay for old farm borrowers' problems.

But in this case, the Senate seems to be saying that we're going to make new home buyers pay for old home buyers' problems. And I just don't think that's appropriate.

On the other hand, if Senator D'Amato is correct, if we're going to have this house price depression, then something like the Senate bill is probably needed just to keep new business sound.

But I'd just like to say that it doesn't really make sense to argue that house prices are going to go up by less than 2 percent, particularly if you're in a 4.5 percent inflation environment.

As John Weicher said, the relevant time horizon is not 6 months, it's maybe 10 years. If you had asked Senator D'Amato in 1979 or 1980 what he thought house price inflation would be in the 1980's, he would have said 10–12 percent, i.e., he would have extrapolated from the recent past.

Now, just because we're in a soft period doesn't mean we should forecast a depression. It doesn't make sense that, over a 10-year period, house prices are going to grow at 3 percent or more below general inflation rates.

So, as I say, I'm very sorry Senator D'Amato wasn't here. And I would ask you to confer this message on to him.

Thank you.

Mr. WEICHER. Mr. Chairman, if I may comment on some of the last few statements.

In the 1970's, when FHA worked, house price inflation ranged from 8–12 percent a year. In the 1970's, almost any insurance premium system would have worked. Our defaults were very low because the mistakes we made were bailed out by the inflation.

No one is now anticipating inflation in house prices at the rate of 8–12 percent a year because no one is expecting the failure of macroeconomic policy in the 1990's that we had in the 1970's, which resulted in house price inflation. And inflation in the general economy, and a weak overall economy.

We can't expect the failures of the Federal Reserve or the executive and legislative branches to bail out FHA's position.

Beyond that, I wanted to say that, with respect to the point that Pat Hendershott raised a moment ago, in fact, deposit insurance premiums were raised when it began to appear, I believe in 1985 in the case of the FSLIC, it began to appear that the Fund was, in fact, not going to be able to meet the claims that were going to be levied on it for a period based on what had been seen at that point.

That proved not to be enough and, ultimately, we did, in fact, have to go to FIRREA and to that kind of approach to the problem.

We are trying to avoid that. We don't really believe that that is an appropriate procedure. FHA is an insurance fund and we don't believe that one class of borrowers should be segregated from another in that way. In a sense, it can be said that the losses in the 1980's were paid for by the people who borrowed in the 1970's, 1960's and earlier, when the Fund was building equity at a very rapid rate.

Finally, I just wanted to say with respect to the 1¼ percent capital, the Price Waterhouse report states that that is a minimum capital ratio, not a desired capital ratio. And the Senate, of course, we suggested to the Senate that we believed that 2 percent would be appropriate by the end of the decade to provide some protection for the Fund. And the Senate adopted that suggestion and, indeed, strengthened that suggestion in the legislation which was passed.

And Senator D'Amato was one of the people of course stressing the need for that additional element of protection.

Senator CRANSTON. Mr. O'Brien.

JOHN O'BRIEN, PRESIDENT AND CEO, CENTRAL PENNSYLVANIA SAVINGS ASSOCIATION, SHAMOKIN, PA

Mr. O'BRIEN. My concern is that one aspect of the statistic about the 20 percent default rate, everybody is talking about safeness and soundness, but my perception is that it's a terrible price for homeowners to pay to think that they've acquired homeownership.

In fact, I think it's a very cruel hoax. So I would hope that the Senate would not support a program that would perpetuate this high default rate—not for safeness and soundness as much as the fact that you are giving people inspiration and aspirations that they can't fulfill.

I think that's cruel and shouldn't be continued.

PHILLIP E. FOREST, VICE CHAIRMAN, SINGLE FAMILY GOVERNMENTAL FINANCE COMMITTEE, NATIONAL ASSOCIATION OF HOME BUILDERS, WASHINGTON, DC

Mr. FOREST. Mr. Chairman, I represent the National Association of Home Builders. Housing production now is at its lowest level since 1982 when interest rates were at 18 percent. The homeownership rate has been declining in the United States since 1979.

We're talking about taking actions that make it harder, not easier, for people to become home owners. I think we need to look very, very carefully at the impact.

Senator D'Amato used some figures of varying estimates of how many people would likely be closed out of the housing markets as a result of the Senate bill.

We tend to agree with the National Association of Realtors in that we believe it's somewhere in the neighborhood of 100,000 families next year.

We don't think that's right.

In the discussion of equity, we seem to have forgotten one basic thing, and that's the definition of equity. Equity is not necessarily the amount of cash the borrower puts on the table. It's the difference between the value of his house and the amount of the loan that's supported by that house.

If he can sell the house, pay off the mortgage and walk away from the table with cash, he has equity, no matter where it came from. And one of the major problems in the administration's proposal and in the problems that have been created over the past years has been the fact that artificially, by including that 3.8 percent with no limit on the total amount of the mortgage, we have created negative equity.

The proposal that Mr. Lasko put forward, which we support, calling for a 1.35 percent premium up front plus periodic premium in the neighborhood of a ½ percent a year, with the 1.35 percent finance, but with a limit that says:

Under no circumstances can the total loan exceed the value of the property without any of the smoke and mirrors that puts the mortgage insurance premium into the computation of what that value is.

And that's where we think we ought to be going. If we can keep the mortgage, the loan to value ratio, somewhere below 100 percent, we will have corrected at least a part of the equity program—by somewhere in the neighborhood of 3 percent. We think that's a good idea.

Mr. LASKO. Mr. Chairman, I am inclined to agree with Senator D'Amato in that maybe the Senate bill is not enough to address the program. But, we don't know. I think it's a good first step.

And as long as the Fund is losing money, something has to be done. Over the last few years, in the savings and loan business, we put off addressing the savings and loan problem until FIRREA was finally passed. And in those intervening years, there were substantial losses accumulated and continue to accumulate.

And so I think we have to address the problem now and not put it off. The FHA program as being proposed in the Senate bill is

better than anything you can get from conventional lenders. I think it's a good first start. And that equity is a key.

And I agree with Mr. O'Brien that you need some equity in your home if you're going to hang on to it. And I agree with Mr. Forest that it is the difference between the value of the property and the mortgage.

And to the degree that the front end premiums, whatever they are, are paid in cash and not financed, I think that we would have a viable program.

NORMAN D. FLYNN, PRESIDENT, NATIONAL ASSOCIATION OF REALTORS, WASHINGTON, DC

Mr. FLYNN. I'd like to address a couple of other questions that Senator D'Amato had raised in his opening comments. And he had asked when he left that I defer these comments until he returned so that he would have an appropriate opportunity to interrupt me and——

Senator D'AMATO. No, no. [Laughter.]

Only to listen to you and to absorb that which needs to be absorbed.

Mr. FLYNN. And I am pleased to have waited until his return because, as Mr. Hendershott said:

In your absence, Senator, it's a lot more fun when you're here. [Laughter.]

And I am pleased to follow my friend, Mr. Lasko, from the Mortgage Bankers, but he's not nearly as friendly as you would have characterized him in your opening commentary. I think you referred to us as "pimps of the mortgage brokers." [Laughter.]

Senator D'AMATO. No, no. I didn't.

Mr. FLYNN. But, going to some of your——

Senator D'AMATO. I take that back. [Laughter.]

Mr. FLYNN. Going to—thank you. Thank you very much. Going to——[Laughter.]

Going to some of your original comments, it cleans up his act a good deal, too, I might add.

Going to some of your original comments, you asked an opening rhetorical question: Does anyone in the room here suggest that we will have 2-4 percent increase in housing prices over the next decade.

And that is, if the housing market is soft now, will the housing market continue to be soft through the decade of the nineties?

I would suggest to you, number one, that the housing market is not as soft as you would think it is because of the very location in which you live, because you're on Long Island and spend a good deal of your time here in Washington, DC, you are looking at those two markets and saying:

My goodness, it must be that the entire real estate market around the country is soft or falling apart or in a disastrous decline.

I'd suggest to you that the numbers do not reflect that, that there are regions in this country that the housing market is very strong. If you look at the Northwest, which is one area you didn't comment on when you were referring to the series conditions

throughout the United States, their housing price increase in the last quarter in the Seattle-Tacoma market was 36.7 percent.

And if I look at the numbers for the first 6 months of this year as it relates to the median price increase in the United States, it was 4.7 percent in what you typify as a soft market.

Granted, there are some soft markets within the country because there is no national real estate market. It is a series of regional, State and even segmented State markets. And so you will have declines and you will have increases throughout the country going on all the time. And short of a total economic malaise in the economy, you should not see a major downturn in the housing market.

But, even if that were to occur, the actuarial soundness of the Fund should be projected over 10 years. And cannot be projected over a 6-month period, or even a 4-month period. Or, if you asked the rhetorical question: Try to sell a condominium here in Washington, DC—to just get an example of how lousy the market is—I'd suggest you try to buy a house for $150,000 in Washington, DC. That's how good the market is because you can't find one; or $100,000.

Try to find a house that the FHA limit really applies to in this market, and you won't find it, because in this market, unless you go 20–25 miles away and have your 2-hour commute every morning.

So, on the bottom line, I think that the market is not going to be as negative as you see it as being.

You suggested that the ad that we ran slamming the door on the American Dream was deceitful and you sort of indicated it was sort of like animal droppings of some sort.

Senator D'AMATO. True.

That I don't withdraw. Absolutely. [Laughter.]

Because you have the sophistication to know how you can improve this program and to deal with some of the shortcomings. And, in my opinion, that was not advanced. It wasn't advanced by Mr. Lasko. He advances it in one hand and wipes it out in the other.

Says lower the premium, lower the charge and then finance that.

And that's not—but now I'm interrupting.

Mr. FLYNN. Yes. Let me make two comments about it. First of all, because of the kind of legislation that was passed in 20 days in the Senate, which was passed without public commentary, which was passed without this kind of open airing from both the industry and the users of the program, it needed to be said and needed to be done, because the American public ought to have an opportunity to see what policy changes are made and can be made in 20 days.

Senator D'AMATO. Not true. Let me tell you why.

My door has always been open to you and every other group, and continues to be. And that's why I say, as friends and as people who have worked together—and we may not agree on a particular issue—if you had come to us, in advance to us, not just positions to defeat an opportunity or an attempt to deal with an opportunity that might require additional up front money, but to go through as we have done today for the first time, this Senator certainly would have factored it in.

But there was not—I have to tell you, and we worked together rather closely, and you know that.

Mr. FLYNN. I do know that.

Senator D'AMATO. It was not that kind of input given to this Senator. And I'm not assessing any blame. This thing came up rather quickly, but we've had exhausted hearings on this.

Yes, the FHA problem is of a more recent vintage in terms of the totality of the housing bill that Senator Cranston and I have been working on for some time. So that's not really accurate.

Mr. FLYNN. In which we've been working very closely.

Senator D'AMATO. Yes——

Mr. FLYNN. But this whole piece of legislation that's advanced by the administration and Secretary Kemp came as a result of the Price Waterhouse study.

Senator D'AMATO. That's true.

Mr. FLYNN. We did not have a copy of that study until the day of their testimony, and that was the only testimony you took.

Senator D'AMATO. Neither did I.

Mr. FLYNN. And is that right for you as a housing expert to get it that late in the game and, 20 days later, vote on it without looking at the impact of what it would have on consumers and users of the program?

Senator D'AMATO. The problem is that we had this report at that point in time. The housing bill was moving forward, and for us to do nothing and for us to sit back as if there were not a problem as it relates to this, would have I think been absolutely negligent and we wouldn't have gotten a housing bill.

Mr. FLYNN. Let me make one last point regarding this, and then one final point about whether this is like an S&L crisis or not.

The fact of the matter is the Price Waterhouse study gave us several options. And Price Waterhouse is quite accurate in that when they put their proposal out, it said: Don't finance the 1.35 percent premium.

And that's the point that you were really getting on Warren's case about earlier. The fact of the matter is we made a modest adjustment to the Price Waterhouse recommendation. But I'll suggest to you the administration made a radical adjustment to Price Waterhouse in their proposal. And the radical adjustment is this. They said:

Don't finance two-thirds of the closing costs.

Price Waterhouse never recommended that. And that put a fatal——

Senator D'AMATO. I did that.

Mr. FLYNN [continuing]. A fatal flaw—a fatal flaw—on the program because you removed it from the very people that the program is supposed to be used for.

Senator D'AMATO. Oh, now——

Mr. FLYNN. And you are red-lining, Senator, the people that need this.

Senator D'AMATO. I'm what?

Mr. FLYNN. You're red-lining the people that need this program.

Senator D'AMATO. No, I'm not. No, I'm not.

Let me just suggest to you again that there's nobody whose indicated that the Price Waterhouse findings, which have suggested

that there is a direct correlationship between the mortgage foreclosures and the lack of adequate up front capital being put in, for the lack of equity being put in, that there is that correlationship, that certainly we have to suggest that there's some way; you can't finance everything.

Otherwise, let's say to every single person: Come on in. Here's your house. Don't put up a penny. You'll just have to pay $1,100 a month. And as long as you can pay it, we don't bring the mortgage foreclosure against you.

Now, if you want to say that that's the way of doing business, then, fine. And that's actually what you're saying.

Mr. FLYNN. Senator D'Amato.

Senator D'AMATO. Let's let everybody come in and mortgage out to 110 percent. What the hell? We can handle more people.

How about we give you a bonus of $25,000 cash, give you a house, you move on in, and we say: And you can finance that over the life of it.

Mr. FLYNN. You're a true-born salesman, no question.

Senator D'AMATO. Well, that's right. You know, we're in this business. You can get hit by not being able to sell. [Laughter.]

But, I mean the point of the matter is you're not then going to have a program. You're going to——

Mr. FLYNN. Let me refer you to page 10 of our testimony, which shows the true loan to value ratios between the Senate proposal and the Vento-Ridge proposal.

And you will see that the Senate proposal has a higher loan to value ratio than does Vento-Ridge.

Your program does not get to the heart of the matter, unfortunately, Senator.

Senator D'AMATO. Oh, no, mine does. Let me just tell you something. Yours doesn't because you're not putting any money up front. And you just totally disregard that.

And as Price Waterhouse said, this issue, as it relates to the insurance premium—rather specious as it relates to the default ratio and the lack of adequate up front moneys put in by the person whose buying a home.

Now let me tell you something. It doesn't mean that I don't care about poor people. And it doesn't mean that I don't want to give people an opportunity to buy homes. I do. I do. And I have worked assiduously to expand the FHA program to increase prior the limits until we ran into this buzz-saw and to the opposition and to the reports.

And I want to tell you something. Do you want to do something? I don't hear anybody talking from your side except Ms. Cincotta, about how to see to it that the abuses in the program, that the default ratios that are taking place, are addressed.

Have you done anything as it relates to that?

Mr. FLYNN. We have some recommendations on management. But let me give you a point on what you want to do. What you want to do, Senator——

Senator D'AMATO. What——

Mr. FLYNN. Senator, what you want to make sure is that nobody loses because if they lose, it's a hardship.

Senator D'AMATO. Oh, no, we know that somebody is going to lose. We know that there are going to be default ratios. We know that people are going to lose their jobs and there will be economic dislocation. We understand that. I'm not suggesting to you that nobody's going to lose.

And I'm not suggesting to you that we have a program that doesn't take risks that let's say the private sector might not. We understand that.

So don't put me at the pointed position that I'm saying that I want to close out everybody.

Do you want to do that? That's demagogy. That ad was demagogy. OK? Do I do it?

I might. [Laughter.]

Mr. FLYNN. Yes, I've heard a little bit this morning. [Laughter.]

Senator D'AMATO. Well, wait a minute. I didn't spend whatever it was to do that kind of thing. And my office has always been open and my door has always been open, and we might disagree and it's still going to be open, because if we can improve upon the legislative proposal, this Senator is not wed to the proposal that the Senate has passed.

If we can make it better, I'm willing to look at it. But I'm not going to because of that misleading characterization that was placed that:

The Congress is going to stop you from buying a home.

The program won't be here. If we continue in the road we're going without encouraging a sounder program than what we're going to see in terms of lowering the default ratios, then what we are going to see is the same kind of public reaction that we have seen where there have been other fiascos and they're going to turn their back on this program.

You're going to lose congressional support for it.

Mr. LASKO. If I could, Mr. D'Amato, we haven't said much about the measures being done to lower defaults outside the arena of downpayments and equity. And I just think that we ought to remember that back in the wintertime, the Congress did pass a HUD Reform Act of 1989. The President signed it. There were over 30 measures taken.

The elimination of investor loans was only one of them. They eliminated the 245 program, GPM loans. They introduced credit checks. You cannot assume an FHA loan without getting a credit check. I can tell you, the lenders do that now. There are strict limitations on buy-downs. Underwriting is tighter. There are controls.

There are over 30 measures taken that we really haven't begun to see the results of yet. And there's no way to measure them.

So I think——

Senator D'AMATO. That's good. That's one for our side. I didn't think we were quite as responsible.

Ms. MEIER. Senator D'Amato, I would also like to say that maybe you would characterize that ad as demagoguery, but although we don't have the money to do ads like that at Consumers Union, I think it is a pretty reasonable, accurate advertisement, primarily because—and this is something that I would like to discuss a little bit more here.

If we do need to do something about the Fund, if we're going to take the Price Waterhouse report as the word, the gospel, which has been what's happened in the few weeks since it's been released, i.e., if we're going to assume we've got to reach 1.25 percent capital levels, which, again, everyone is assuming, then we've got two proposals here—the Cranston-Vento-Ridge proposal versus the administration's proposal, and, actually, we have three. We have yours.

We've got already Price Waterhouse stating very recently that the Cranston approach and the Vento-Ridge approach, which are substantially identical, will reach actuarial soundness. That it will reach the 1.25 percent capital standard required under Price Waterhouse in a few years.

That proposal is far more sensitive to the needs of first-time home buyers, minimizes any increased up front cash requirements. So, why aren't we taking that proposal? If we can achieve both goals——

Senator D'AMATO. I haven't heard Mr. Weicher testify to that, nor have I heard——

Ms. MEIER. Well, I——

Senator D'AMATO. No, I——

Ms. MEIER. I have a spread sheet that came from Price Waterhouse that analyzes the capital ratios over time.

Senator D'AMATO. Well, why don't we have them? They're right here. Why don't we have them respond to that?

Senator CRANSTON. Let me say my understanding is that Price Waterhouse stated that the proposal I made would be actuarily sound not quite as soon as the administration proposal.

Is that correct?

Mr. WADDEL. That is correct, Senator Cranston.

And I didn't get a chance to make an opening statement, but in attachment one to my testimony, I show the capital ratio that would be achieved under S. 566 and under the Vento proposal. And I show various reductions in the level of housing demand to accommodate some of the concerns that were raised here about loss of business within the FHA Fund.

And I think the general conclusion that I would reach from attachment one is that the S. 566 would achieve the actuarial target, the capital ratio target, in about 2 years.

And the Vento-Ridge-Cranston proposal would take about 2 years longer in general.

Senator CRANSTON. Can I add one point?

Your analysis was based upon the first draft in my proposal. We modified it in a way that we believe would then achieve the actuarial soundness within the required 18 months.

Mr. WADDEL. That is not correct, Mr. Chairman. There were two versions of the proposal.

Mr. WEICHER. This is based on your second proposal as it is based on the second Vento-Ridge proposal. It is neither the first Vento-Ridge proposal nor the first version of your proposal.

Senator CRANSTON. Don Campbell.

Mr. CAMPBELL. The proposal that Senator Cranston was to offer would require in law that the 1.25 percent goal be achieved within 18 months of passage of the act. That was the final proposal that Senator Cranston was considering offering.

Mr. WEICHER. What we asked Price Waterhouse to do was to work out the implications of the specific changes in the premium and in closing costs and downpayment and whatever else might be involved. And then to say at what point that proposal would achieve the 1¼ percent capital target or any other capital ratio.

And not to price out what else would be required if the decision was that, since this proposal did not reach 1¼ percent in that period, what else would the Secretary do at that point to reach it.

So, without the constraint, the whole proposal in that sense would not have worked without doing something in addition to achieve the target.

Mr. CAMPBELL. That may have been because the future is uncertain. That is why the proposal did include the requirement that this be continually monitored and changes made. That part of Senator Cranston's proposal was included in this in a passed bill.

Mr. WEICHER. Exactly. That strengthened the bill in our judgment.

If I may say a couple of things about the administrative issue and the reforms passed last year for which we are very pleased that the Senate and the Congress did, in fact, pass our reform bill. It was passed, indeed, in a matter of something like 6 or 8 weeks from the time the Secretary presented it.

Those reforms, we anticipate, will help FHA. Price Waterhouse says to us, and I certainly believe this, that we cannot count the savings for those reforms until they occur. When they occur, they will show up in the form of a lower default rate or a lower loss rate per default, along that line, and we will be in perhaps a little bit better position. We certainly are working for that.

But it seemed to us to be totally irresponsible to come to you and to say, we have a problem, the problem is getting worse. We don't want to do anything about the structure of the program. We're just going to ask you to count on administrative reforms which we are just starting, and this after several years of the Department being a byword for incompetence and inefficiency. That would have been, in our judgment, smoke and mirrors of the worst sort. And we felt that we could not, in conscience, say to you that all of the administrative reforms were going to solve this problem and turn us from losing $200 and $300 million a year to adding $700 million a year to our reserves.

We proposed to lower the default rate. Our proposal lowers our default rate, and this is important, from 90,000 a year to about 85,000 a year. Senator D'Amato's proposal would have lowered it to 80,000 a year, and in our judgement, all of those are still too high. The Vento-Ridge proposal would have raised it to 95,000 a year, and I think that is clearly a step in the wrong direction. We can always raise premiums so that we can have more home buyers and have more defaults. I don't think any of us really want that.

We tried to require everyone to have some real equity in their home by requiring them to pay two-thirds of the closing costs up front. It doesn't make a lot of sense to us to allow people to finance the cost of the title search over the next 30 years. Senator D'Amato went farther and would have required the payment of all closing costs up front. And I think that's probably where Mrs. Cincotta is,

from the statement that Mr. Shaw presented at the earlier hearing.

We do not believe that we should be financing all of the closing costs of people who buy homes. And we're about the only people who do that, and it contributes to our problem.

Senator CRANSTON. May I say one thing? I have to go in the back and meet with Carla Hills briefly on a trade matter. And Al, you carry on, and I'll get back if I can. If you have to leave, Don Campbell will carry on.

There are a couple of points that I want to make sure we cover before we break up. I would like to ask one of those questions, now, and Don may cover a couple of others before I get back.

But I gathered from one thing that was said awhile ago, that where there is a declining value of homes in Washington and some other places in the country, that may be at the upper levels and not at the lower levels where we are really talking about. If that's the case, I'd like to get that clearly understood. Please explain that in my absence. And Don Campbell and Al will hear your response on that point.

Mr. BARMORE. Not responding to that question, but the earlier line of discussion, there are only two variables that you have to improve the soundness of the fund. One is the price that you talk about a lot; the other one is the risk. And if you don't deal with the risk, then you have to charge a very high price, which increases monthly payments, and therefore makes payment more difficult. Risk is dealt with by equity, as defined by Mr. Forrest.

Senator D'AMATO. Would you take the mike?

Mr. BARMORE. The difference between what you can sell the house for and what you owe. Risk is clearly related to that equity. Our own experience in our own regulatory environment says, under no cases may you insure a loan that exceeds 95 percent of what the house can be sold for. It doesn't matter what you're financing. You can't finance anything above 95 percent.

The reason insurance regulators require that is that they know full well during difficult times, that there is an exponential default rate when you get less than that. So when you start talking about no more cash required at closing, no matter how you count it, whether you're counting it as premiums, closing costs or whatever, if there is no more difference between what you can sell it for and what you owe, you haven't reduced the risk.

If you don't reduce the risk, you're not going to reduce the default rates, and if you don't do that, this program is in serious trouble, no matter what you do with the premiums.

Senator D'AMATO. Does anyone want to respond to that?

Mr. CLAY. I would.

Senator D'AMATO. Let Mr. Clay respond to that.

And then I would like to hear our economist respond to that. Professor, were you listening?

Mr. HENDERSHOTT. Certainly, certainly, all the time, Senator.

Senator D'AMATO. You know, in class, you catch the guys. Don't you do that once in a while? [Laughter.]

Mr. HENDERSHOTT. That's right, professor, that's right.

Senator D'AMATO. I love to teach; it's fun.

Go ahead.

Mr. CLAY. The correlation between equity and default, to my recollection, the FHA downpayment and up-front cash requirement has been the same for a long time. And if there was a direct correlation between equity and default, why hasn't the insurance fund gotten in trouble before now?

Senator D'AMATO. Well, if I might, you will see that there is a steady corrosion of the fund over a period of time.

Mr. CLAY. After 1980. The Price Waterhouse statement says that the reason that it still has what it has is because of the equity that has accumulated prior to 1980. It appears that the 20 percent—and I'm sorry that I haven't read the Price Waterhouse statement, I've just read parts of it here—that the problem should be focused on the 20 percent. I mean, what is it? Are they investors? Are they people who are living in their homes? Or what?

And the provisions that were referred to by Mr. Lasko in the 1989 bill, the elimination of the 245, the assumption provisions, I believe has been, from what I've heard, the biggest source of the problem.

Now, in areas that we serve, the inner city areas, until the Community Reinvestment Act, the conventional lenders just wrote it off. I mean, they have said that we do not want to make loans in the inner city. We don't want to make them, and we set up all kind of artificial barriers like minimum loans, houses in neighborhoods that I sell, we still have houses that sell for less than $25,000. But there are very few lenders. And there's some who deal with FHA programs in our area say they're not going to make loans under $30,000 or $40,000.

Now, if we eliminate FHA as an alternative for our home buyers, I mean, the ad that the realtors had in is correct; you are eliminating a lot of people who——

Senator D'AMATO. Well, Mr. Clay, I don't think our proposal certainly wasn't intended to eliminate to FHA. And I don't believe that by requiring two-thirds of the closing costs, where we have a home, where you have a mortgage of $30,000, and now we're talking about a rather modest closing cost, is going to be eliminating FHA, or should be considered so extreme.

Now, people are saying that putting up two-thirds of the closing costs and not being able to finance that as well is a deficiency in our proposal, then let them say it. And if that's what they're saying, and I see some people here nodding their heads, and let the record indicate that there are some who are saying that by putting up two-thirds of the closing costs, by being forced to pay for it, that that in essence is working against the program, or I don't want to characterize it, but they disagree with that, OK, let's put it that way. I just don't see a program that is as good anyplace, and I don't believe that it's requiring people to do too much to put up two-thirds, two-thirds, we didn't even say the whole closing cost. By the way, I would, my druthers would be that you'd have to pay for the entire closing cost. People are then going to take an interest in what takes place. It's not going to be just rolled into a package so that they don't care, and they have no feeling about it. There's nothing at risk that they're placing and you haven't reduced the risk.

Ms. Cincotta.

Ms. CINCOTTA. I still don't understand. I mean, I think that sign they had up that if we do all this stuff, you all do all this stuff, 100,000 people are not going to have a home. To me, it's phony if you keep 100,000 people that year in their home. It balances out. I think it's better to have somebody wait a little longer than get them in a home that they can't afford and they're out on the street and they've lost their credit, they've lost their downpayment, they've lost their feelings. You hurt people more that way than you do by keeping them out of a home for a couple more months until they get a little bit more money. I think there's creative ways we can help people with grants for closing costs.

In Chicago, we have a program we applied for under the Affordable Housing Program with Federal S&L, the bailout money, where it'll pay up to $2,000 a buyer for low income buyer to pay for their closing costs. I think that's where we're creative. But if you put a person in a home and all you realtors make your money and you're gone. Mortgage bankers get 100 percent paid for. They make theirs but, damn it, the neighborhood suffers, the morale suffers, and the people suffer. And I am so tired of looking at boarded up buildings in my neighborhood and in every neighborhood across this country, that's pretty much 100 percent FHA, and people who make money off the program put their money in their pockets, stick the people in the home, and don't have to live with what happens afterward.

I sound like you. I'm sorry.

Ms. MEIER. In direct response to you, Gail, a couple things. One is, I think that it would be nonsensical to foreclose this program or make it more difficult for consumers to use this program by increasing cash requirements, and then turn around and scramble for grant money to try to reverse the damage. It just doesn't make any sense.

Ms. CINCOTTA. One they owe and one they don't owe. One they'd have a home that they'd have equity in it, and two, they would have a home that's being mortgaged for anywhere, they're talking about 102 percent. There's cases of 108 percent of appraised value. I mean, that is nonsense when you have something like that.

Ms. MEIER. Well, you can achieve the same goal of creating more equity by lowering the upfront premium and keeping it financable.

Senator D'AMATO. No, you can't. How do you achieve greater equity by not putting one additional dollar up front? Show me.

Ms. MEIER. Well, we went through this earlier, that you lower the up front insurance premium to the extent it's financed, by lowering the up-front insurance premium, you're lowering the loan to value ratio, which is creating more equity. It's simple. It works. It's true.

Senator D'AMATO. No, it's not true. You don't put one dollar of additional equity up.

Ms. MEIER. And then a second response is----

Senator D'AMATO. Well, I'm not going to tell you something is true, and just sign off because you have the floor. And I disagree with it anyway.

Ms. MEIER. And to the extent that I know your organization has experienced high rates of defaults with 100 percent loan to value ratios or greater, I know the witness from your organization over on the House side a couple of weeks ago claimed that the default

rates with high loan to value borrowers with whom you had experience, was five times greater with one particular type of mortgage lender which were mortgage brokers. To me, that says something to the effect that, yeah, maybe there's some correlation between high LTV's and defaults, but that the important factor to look at, and one of the biggest problems creating the defaults, is who your lender is and how they're underwriting the loan.

Ms. CINCOTTA. You're talking about very unsophisticated buyers, quite often any first time home buyer, but especially in low income. The problem is, if you run into a problem and you don't have any cash in your house, you're going to lose your house, you're going to lose your credit rating, you're going to lose everything. If you run into a problem and there is some equity, and say you've been there a year, and you could get counseling, but even if you had to move out, you might be able to sell the house, keep your credit, keep a little cash, and not leave an abandoned building.

Ms. MEIER. One last thing just before I lose the mike is on the point that I think we really left too quickly a few moments ago, which is the difference between the Cranston-Vento-Ridge approach and the administration's approach which, from our standpoint, both achieve actuarial soundness but one does it with much more sensitivity and reflects good public policy. We had heard from Price Waterhouse on the fact that, true, the Cranston-Vento-Ridge approach does achieve actuarial soundness, but it takes a couple more years. But one thing I think everyone has to realize is that—and I double checked this with the Price Waterhouse people between having the mike—the Cranston proposal, according to their analysis, achieves a 1.25 percent capital standard on new business, on new FHA business, immediately. We don't have to wait for 3 or 4 years. So, to the extent we're looking at some lag between the administration's proposal and the Cranston proposal, we're looking at a lag in having current FHA revenues catch up with losses from old business. So I think, to the extent we're burdening new FHA borrowers to make up for the problems during the past, that a 2 year lag is liveable.

Mr. WEICHER. Senator D'Amato, if I could comment on that. Both proposals, and as did your proposal, achieved the 1.25 percent on new business, but the Price Waterhouse analysis told us that we needed 1.25 percent as a minimum on all of our business, and in fact if prices start to decline, or if they grow more slowly than Price Waterhouse has said they will, that will apply to the old business as well as the new business, and we will have defaults on the old business and we'll have defaults on the old business sooner than we'll have defaults on the new business. And we believe that we need protection for the entire body of business we are doing. We can't simply—we could, in a sense, grow out of the problem in that, if we did 1.25 percent on new business for 30 years, all the old business would run off and we'd have 1.25 percent. But we need the capital.

. In a sense, it's easy to design something which will solve the problem for the new business but we need to have a capital reserve against the entire book of business that we are doing, because that's where we'll have the loss.

Mr. FLYNN. Mr. Weicher, What's the condition of the fund right now in 1990?

Mr. WEICHER. We have 1 percent capital against the amount of the insurance.

Mr. FLYNN. What's the condition of the income in the fund in 1990?

Mr. WEICHER. In present value terms, we're losing $350 million on each book of business that we do.

Mr. FLYNN. What are you doing in 1990? I don't want to know present value. What are you doing in 1990?

Mr. WEICHER. This is a problem that came up in the House hearing. Again, on a cash basis in the first 6 months of the fiscal year, as Mr. Vento asked the Under Secretary, FHA has taken in $80 million. That is the premiums that we have received and earned on the business we are doing now, and on the business we have done in the recent past, offsetting against that the losses that we have incurred in the last in that period of 6 months. That's not a particularly good picture of where the overall soundness of the fund is, and where the fund is going.

It is as if I made a commitment to buy a house from a home builder, and I give the home builder a downpayment, an up front payment, and the homebuilder has made the commitment on that basis that he will build the house for me. And in that situation, from the home builder's standpoint, he's received $500 or $5,000 or some number of dollars from me, and that's the cash in that period, and he's made a commitment that over the next few months, he's going to hire people to build the house and buy the things to build the house, and I'm going to pay him the money and he's going to pay it out to them. If you look only at the first 6 months, he's made $5,000 or $500 or whatever it is from me, but then he has to honor the commitment and build the house.

We've taken in premium income in the last 6 months on the business we've done in the last 6 months. We can expect the losses on that to come in in 2 and 3 and 4 and 5 years. And Price Waterhouse tells us that, given the policies we're following, we will have those losses in the next 2 and 3 and 4 and 5 years, and that plus $80 million will turn into some minuses.

Mr. FLYNN. But what is the actual dollar amount of the capital balance that you have now? Is it $2.6 billion or $3.229 billion?

Mr. WEICHER. We expect $2.9 billion at the end of fiscal year 1990.

Mr. FLYNN. What is the $3.229 billion in the spread sheet?

Mr. WEICHER. That's going into fiscal year 1990 based on the analysis that Price Waterhouse did, using the latest data that we got from the Census Bureau, which differs from what's in the body of the report which I take is your question, and is based on the later revised analysis that's described in appendix D, using the updated information that they got which was published May.

Senator D'AMATO. $80 million ain't no great amount of money out for 6 months and that experience really does not, that's the point.

Mr. FLYNN. The point is the fund's a lot healthier than he testified, because it is $3.229 billion by their recent numbers; $2.6 billion by their testimony in the House just a week and a half ago.

Mr. CRAREN. That is incorrect.

Senator D'AMATO. You know, the most incredible thing I heard was when the S&L guys came to us and said we don't need $15 billion, only get $5 billion. And we had that. I mean, it was incredible. No, we don't need it, we're good, you know. And now it's almost deja vu. It's like I'm hearing, don't worry about the fund. Oh, this fund is sounder than you guys have said. And that's not true and Price Waterhouse said it.

What were you going to say?

Mr. CRAREN. I don't know where he got those figures but those are inaccurate. We're talking about book versus market value differences and our last audit, it was $1.8 billion.

Senator D'AMATO. $1.8 billion.

Mr. CRAREN. $1.8 billion.

Senator D'AMATO. Not $2.8 billion?

Mr. CRAREN. Or $3.2 billion. So I don't know where you got those numbers, but they're suspect.

Ms. MEIER. $1.8 billion reflecting what?

Mr. WADDELL. Let me just say, the $1.8 billion number is Tom's accounting value, it's the book value of the fund. The $3.2 billion number was derived pretty much at the request of your analyst because one of the Price series that goes into the analysis changed, as John said, in May. We updated the analysis using the changed price series, and so the economic value increased from about $2.6 million in our study to the $3.2 million that's referred to in appendix D of our report. So it's really just a change in the price series by the Government and we updated our analysis to include the most recent numbers.

Mr. FLYNN. It's my understanding we did not request that, but that the Government did because they wouldn't reach the $1.25 billion in 2 years if they didn't use the higher number.

Mr. WEICHER. We held a meeting with representatives of the interest groups, and the economist for the realtors made the point, why didn't you use the numbers in the appendix, and the answer was, we did not have the time. We got it too late to do the whole report over again. But we have priced out the difference under the old system, we have 1 percent capital at the end of 1989; and under the new data, we have 1 percent capital at the end of 1990. That's a help. But under both of them, we are losing money on each year's new business at the same rate. And we will lose $200 million a year and $150 million more from distributive shares.

Senator D'AMATO. Norman, I'm going to tell you something. You're a great association to be taking on this charge in this manner and I think that we can probably and should improve upon the Senate version. But I have to tell you something. When you say, let's do it without attempting to increase equity, without addressing the under funding problem, without requiring that the homeowner have more invested, and thereby just continuing basically the same problem, that fails and that falls short of what we should be doing as we try to work toward common solutions.

Now, that's—I'm not going to go further, because then it'll unstring me into one of my tirades.

Mr. FLYNN. Sure, I understand. And we don't want to do that. But I have referred you to page 10 of our testimony which really

looks at true loan to value on two or three occasions. And if you will look at page 10, you will note that the true loan to value under the Senate proposal a is a higher loan to value ratio than under Vento-Ridge.

Senator D'AMATO. I understand and I have to tell you something. I may very well be willing to move to modify in the manner in which we deal with that, but which will require there being more money, more equity being put up. I'm not going to back off a situation. And, by the way, you may very well be able to get and build a great coalition. I've lost before. I've lost many more battles than I've won. It doesn't bother me. You fight for what you think is right. And you're able to get all these fellows over there in the House to come together and all the realtors get on their back and what not, and they come together and they sustain this position, that's OK with me. You know, if they want to do that. I think it's going to be bad for the FHA in the fullness of time; it's going to be bad for exactly the people you want to help, low income people. It's going to be bad that you're going to be putting more people out on the street. But that's OK, through foreclosures that shouldn't have taken place. So we'll have that fight. I'm not going to back off there being more money put up front so that there's lower risk and there's more equity.

Now that's what we come down to. And you can deny the soundness of Price Waterhouse's suggestion, as it relates to that principle, and that's exactly what you're doing because you're saying, lower the insurance premium and just pay it out over a period of time, because if you lower the premium, there's less at risk, and you haven't. And really in essence, there may be less at risk total dollars but certainly not for the person who's going in, and you're going to have just the same kind of default patterns. And we could argue this day in and day out.

I'm going to ask the Professor to make his observation.

Professor.

Mr. HENDERSHOTT. I want to go back to a point that I made in your absence that hasn't been picked up on a whole lot. People have talked about how irresponsible it is to go forward as we are, and I think everybody agrees that it would be irresponsible to make no changes; there's no question about that. And I think most people are signing off on at least what Price Waterhouse says is needed.

What troubles me is the legislation being proposed are way beyond Price Waterhouse. And, in effect, what they're saying is that new home buyers have to pay premiums not just to make their business sound, but have to make up for the fact that the premiums weren't high enough in the 1980's, i.e., they are being asked to build capital for the old business.

Now, we had a deposit insurance problem and we did not solve or attempt to solve the deposit insurance problem by making new depositors pay higher fees. John Weicher pointed out that we got a little money in by asking every depositor to pay higher fees, but certainly not just new depositors, and certainly no where near 5 percent of the total cost. When we had problems with the farmer's home loan thing, Senator are you alert here?

Senator D'AMATO. I'm listening.

Mr. HENDERSHOTT. OK. When you had problems with the Farmer's Home Loans, did you ask the new borrowers to pay for the $4 billion bailout of the fund? No. The new borrowers weren't asked to pay for it.

Why is it that new home owners have to pay for sins that were made in the past, whether they were in the bowels of HUD or whether they were made on the hill, or wherever they were made. Why is it that in this one case we're going to make the new borrowers pay for all the past old sins?

Mr. SEATON. I think that question's been answered, Senator, when they indicated that the fund was up at 5 percent and that was accumulated by those people that were using the program back in the 1960's and 1970's, and now it's gone down to 1 percent, which is not too far from the 1.25. All we're trying to do is to stabilize the fund with these measures. Because if we stay the way we are, we'll continue to lose and the MMIF will eventually go bankrupt.

So what's been paid for has been paid for by those in previous decades, and all we're trying to do now is to stabilize it and come up with a program that'll pay as you go, as an ongoing program.

Mr. HENDERSHOTT. Your statement would be correct if we were currently at 1.25 percent. We are not currently at 1.25 percent, we're currently under 1 percent. And your raising the additional funds to get capital up to 1.25 percent on all these past billions of dollars of business by penalizing new home buyers in the next two years. I mean, that seems a little silly to me. I don't understand that.

Senator D'AMATO. OK, that's a good point.

Do you have another observation you'd like to make?

Mr. HENDERSHOTT. Me?

Senator D'AMATO. Yes. Sure. What the heck, you know, you don't just pick the people who agree with you.

Mr. HENDERSHOTT. OK. I'd like to make an observation on this 3.8 percent up front.

Senator D'AMATO. By the way, let me ask you a question. What do you suggest, that we don't do anything?

Mr. HENDERSHOTT. No. I think I prefaced my remark by saying that everybody agrees, and certainly I, as a contributor to the Price Waterhouse report, agree that we should do what Price Waterhouse called for. I mean, there may be somebody in this room that doesn't want to do that, but I think there are very very few.

The point is that——

Senator D'AMATO. Well, I don't think Mr. Flynn wants to do what Price Waterhouse suggests, do you?

Mr. FLYNN. We sure do.

Mr. HENDERSHOTT. He would love to do it.

Senator D'AMATO. Oh, yeah.

Mr. FLYNN. Immediately.

Mr. HENDERSHOTT. I'd like to get back to the 3.8 percent.

Senator D'AMATO. You mean, don't put the two-thirds closing, don't——

Mr. FLYNN. We want the Vento-Ridge solution, that's the key.

Go ahead, Pat.

Mr. HENDERSHOTT. The 3.8 percent premium up front was introduced, as you may recall, in 1983 and it's had numerous bad impacts. We all agree that it likely lead to some additional defaults in the 1980's. It also led us to misunderstand how bad the Fund was. One of the reasons we're in the problem we are today, rather than 2 or 3 years ago, is because of this funny accounting system where you bring in all the cash up front. Mr. Flynn will argue that the fund's in great shape because all this cash is flowing in. It's that up front premium that causes us to be mislead.

Another problem that Mr. Barmore would certainly agree with is we raised the loan limits—excuse me; you raised the loan limits in 1988, not because of any great philosophical feeling that we ought to expand the program, but simply to get more Federal revenues. That was the reason that the loan limits were raised in 1988.

Senator D'AMATO. Well, wait a minute. That may be the reasons that some advanced. It certainly wasn't the reason that others advanced who saw that there were many homes in their region and people who simply didn't qualify for FHA. So——

Mr. HENDERSHOTT. I understand the argument, but I think it's a fair assumption that the loan limit increase would not have passed if it weren't going to raise some revenue. So it seems to me, the 3.8 percent premium being paid up front and being borrowed has caused us problems in the past; it hides problems and it causes other problems. And it would be reasonable to get rid of that for those reasons alone.

Senator D'AMATO. Well, that might be a pretty good way, to reduce the 3.8 percent to 1.35 percent cash up front. Let the guy who buys the house has to put up front.

Mr. HENDERSHOTT. I think a lot of people would go along with that, although certainly not everyone in this room.

Senator D'AMATO. Well, who knows, maybe they will.

Mr. HENDERSHOTT. But we can't get everything for everybody.

Mr. BARMORE. You have to get the economic equivalent of the premiums proposed.

Mr. WEICHER. Mr. Chairman, can I say one thing in response to what Pat said about——

Senator D'AMATO. Weicher, how do you like 1.35 percent up front plus the premium financed over 30 years, the balance of it?

Mr. WEICHER. We will go back, if you wish, and we will work out exactly what the structure of that would have to be and how much would have to be paid out over the next 30 years.

Senator D'AMATO. Would you take a look at that?

Mr. WEICHER. We will do that for you.

Senator D'AMATO. And you'll share that with the committee?

Mr. WEICHER. We will do that.

Senator D'AMATO. And then we'll get a hold of Mr. Flynn and Mr. Lasko and who knows, maybe we can even come to a compromise.

Mr. WEICHER. And we will tell you how many defaults it might cause, as well. We will give you as much information on it as we can.

Senator D'AMATO. It's going to have less defaults because you've got more money in there.

Mr. WEICHER. We will make sure.

Senator D'AMATO. We're not taking their proposal now.

Mr. WEICHER. All right. It's 1.35 percent up front in cash.

Senator D'AMATO. Absolutely.

Mr. WEICHER. What that will be over the next 30 years.

Senator D'AMATO. And if you want to run, if you haven't already run, which I think you have, 1.35 percent the way they've suggested it, financing this thing.

Mr. WEICHER. We have run a version of that.

Senator D'AMATO. Then let's look at all of the numbers in comparison, and then let's take a look and see where we're at.

Mr. WEICHER. That is the Vento-Ridge proposal.

Senator D'AMATO. I understand that.

Mr. WEICHER. And that is the one that we have described that will get us the additional defaults.

Senator D'AMATO. Will get us additional defaults.

Mr. WEICHER. That's right.

Senator D'AMATO. Well, let's find out if we put 1.35 in cash, all right, that modification and see what takes place.

Mr. WEICHER. All right.

If I could just say one thing about the 3.8 percent premium and the budget accounting. The 3.8 percent does not show up, it shows up with FHA when it's earned; it doesn't show up as 3.8 percent in cash in the year that the loan is taken out. And we recorded over a period of time, and it's earned at a rate of on average something under a ½ percent a year. So if anything, it would tend to understate the position of the fund relative to the previous way of doing the premium. And of course, reversing the premium structure won't solve the problem. Going back to 50 basis points a year for 30 years won't solve the problem.

Mr. HENDERSHOTT. If you look—and maybe you could do this for the Senator—if you look in the 1980's at how rapidly that premium was taken in—cash was accumulated—relative to the general time profile of defaults that were expected to get on the 1980's book, the up front premium has definitely made things look better.

Mr. WEICHER. But we score it at a little less, I think, than a ½ percent a year and that's the way we scored the old premium because that's the way the old premium came in and was earned. So I don't think that's going to have much of an impact. I'm sure there's some minor impact on the cash position.

Senator D'AMATO. Mr. Lasko.

Mr. LASKO. Thank you, Senator.

I'd like to come back one more time to this question of equity, and I've had a chance to look at Mr. Waddell's prepared statement here. And attached to his statement are three examples that compare, among other things, the Senate bill with the Vento-Ridge bill. And what leaps off the page at me is that here we have Price Waterhouse, themselves, saying that the Vento-Ridge approach provides more equity in all three examples, than the Senate approach.

Now, having said that, let me make another observation. I think when we talk about equity, some of us are talking——

Mr. WADDELL. I'm sorry. Could you expand on that, because I don't read my testimony the same way you do.

Mr. LASKO. I was about to expand on it, yes. I was about to expand on it.

I think when we talk about equity, some of us are talking about two different things. The definition of equity that I've heard the most consensus on is the amount of the mortgage subtracted from the true value of the house. And that's the definition of equity that would be most meaningful to me. In other words, does somebody living in the house have an incentive to walk away from it if the mortgage exceeds the value, say.

And the other definition is cash, just how much cash did the buyer take out of their pocket. The key differences between the Vento-Ridge approach and the Senate approach are that the Vento-Ridge approach does provide more equity in terms of mortgage versus value.

Senator D'AMATO. Yes, yes. OK. There's no argument about that. There is absolutely no argument about that. But I think there's also another kind of equity as it relates to that which a person has actually invested in that house themselves.

Having said that, I am willing to look at this. But I want to tell you something. There's no way that this Senator—you may get, you know, you can twist a lot of arms, you guys are good, you've got a lot of power there, and you may very well be able to convince people that let's just continue this situation and we'll show that there's less at risk because we don't put the premium the 3.85 percent up front, and then finance it in the package, therefore there is less at risk in that manner. Concede you.

But I want to tell you something. If we don't have people putting more up, you're just going to create more defaults, and that's what the administration is saying. I don't believe they're going to sign off on it. Although, look, you've got a lot of swag; you may be able to convince them. You're not—no, I'm calling it the way I see it. You may be able to get them, you may be able to build a coalition, but I'm not going to sign off on it. That doesn't mean that you still may not win. And I'm telling you, I'm going to look to Price Waterhouse and the administration to give us the figures as it relates to putting up.

Oh, gee, saved by the bell, all of us. Thank you.

Don, have you got any more questions? I've got to vote.

Mr. CAMPBELL. Warren, please finish your comment.

Mr. LASKO. Well, I'll just wrap up, Don, by saying we're certainly not trying to twist anybody's arm. I think you hear the emotion here because this is an exceedingly important decision that's about to be made. And certainly speaking on behalf of the lending community, we don't want to twist anybody's arm, but we want to see the right thing done. And we genuinely believe that whether it's Senator Cranston's proposal or we call it the Vento-Ridge proposal, that's the right thing, not for the lenders, not for the builders, not for the realtors, but it's the right thing for that moderate income family renting a house who has modest savings and for whom FHA can make the difference between becoming homeowners now or in the next few months or a year or so, and perhaps never getting into a house at all. And that's what we're here trying to make compelling arguments because once this decision is made and put into law, it's going to be very very difficult to change. So it's exceedingly important to make the right decision at this point.

Mr. CAMPBELL. Mr. Clay.

Mr. CLAY. One more thing. And that is, again, the correlation between equity, FHA has been in business since the 1940's, downpayment wasn't higher than in the 1950's, the 1960's or the 1970's, than they are now. The correlation between equity and default I believe is not quite accurate. If it was, then the fund would have been in trouble long before now. If I'm wrong, please explain to me how wrong I am. The correlation between equity or the inflationary correlation and default, although how be it inflation was higher in the 1970's, but in the 1960's and the 1950's, it wasn't as high as it was in the 1970's, and if that was true, then the fund would have been in trouble during that period of time. I don't know what that 20 percent is, and that's where I'm lost. That 20 percent, in my judgment, is what should be dealt with, an analysis of who the 20 percent are, and measures taken to correct the 20 percent. I don't believe that it's 20 percent of home buyers, particularly home buyers that we service, who are in default. I believe it's something else.

I would like to hear a response to those two questions I raised.

Mr. WEICHER. Could I respond to that, Don?

Mr. CAMPBELL. Yes, certainly.

Mr. WEICHER. The big difference between the 1960's and 1970's and the 1980's, is the rate of house price appreciation. If you had 3 percent down on a typical house in the 1970's, you could expect the value of the house to appreciate by 8 to 12 percent a year, which meant that after 1 year, you had an equity in the house of 10 or 12 percent on average, and after 2 years, you had an equity of close to 20 percent on average, and you had a real stake in it. There were still people who defaulted because their house didn't appreciate at the average, and there are people whose houses did not appreciate and declined in value.

If you start from a base where you have a 3 percent equity in the home and the prices are going up by 2 to 3 percent or 4 percent a year on average, then maybe after 1 year, the average person will have 6 or 7 percent, but there will be more of them who will have negative equity. There'll be more of them with less equity and over a period of time, we will have more defaults in that situation.

With respect to the 1950's and the earlier years, FHA's downpayments have been relaxed over a very long period of time. The program that we had in the 1980's is very different than the program that we had in the 1950's. We had higher downpayment requirements, we had shorter terms of mortgages, and we are talking about a different entity.

I think if we went back to the way we did FHA when it was first established in those terms, we would be talking about 20-year mortgages with 5 percent down to begin with. And in that situation, we would have a different looking fund. I don't even know how we could evaluate that in the absence of 20-year mortgages.

Senator CRANSTON. Can I interrupt what you're doing just to say, I have to go now, we've recessed to a democratic conference. I'd like Don to carry on with you as long as possible. I thank you very much for your participation. We've had a very lively discussion, and a lot more information that's of help to us has been put forward by all of you.

I'd like to ask one question.

Was there any response to the question I asked about, are the lower prices that homes are going for primarily in the areas where that's happening restricted to homes in the $200,000 and up level, with not so much of that happening in the lower brackets? Do you know? Are there any statistics?

Mr. BARMORE. Our experience is that home price fluctuation varies dramatically by market. For example, I live in Raleigh, NC. During the years of the expansion of Raleigh as a center for the American Airlines hub, the high priced houses were booming because that's who was moving to town.

Today, the lower priced houses are moving because they're moving in the airline stewardesses and the ticket counter specialists. So a lot depends on the make up of a given market at a given time.

Senator CRANSTON. I'm going to leave it to Don and each of you to make sure we cover whatever other ground we should cover for our record and for our guidance. We don't know where we're going to wind up on this particular topic because we don't know what the House will do, and we don't know what will happen in the conference with the House. And I'm not even sure when the House is going to bring up the bill. It may not be until after the recess. I hope it's before, so we have time to deal with it as thoughtfully as possible before our session winds down.

I'm determined to do what I can to see to it that we achieve an actuarially sound FHA without excluding more people than we have to, if any, from the process of getting homes. So, I'm still open to finding a way to do that, and whatever help you can give us in finding that way, consistent with something that we cannot provoke a veto by doing, we want to do.

So thank you all very very much.

Ms. MEIER. Don.

Mr. CAMPBELL. Yes, Michelle?

Ms. MEIER. Just one brief point. I know I'm going to have to go too, pretty soon. But the goal the chairman just stated as trying to achieve actuarial soundness in the least burdensome way, I think that should be everybody's goal. And I do think that the Cranston-Vento-Ridge approach is the right way to go in achieving that goal.

One last thing, just for the record I'd like to state, we do have problems with the Cranston approach and the Vento-Ridge approach, on the 2 percent capital requirement in 10-year period of time. We do think that, given the basis on which Price Waterhouse derived the recommended 1.25 percent, which allows for a margin of error, that at this point in time, that should be the capital standard we should be shooting for. I think before we start setting in stone, which we do when we enact it into legislation, a 2 percent capital requirement, that we need some more information, and we should come back and look at this next year. But for right now, I think all that's really urgently needed, if anything, is meeting the 1.25 percent capital standard. Again, it allows for a margin of error of 25 percent.

Mr. CAMPBELL. Thank you.

Norman.

Mr. FLYNN. One last comment for the record about the political nature of the environment in which this decision is being made.

It's unfortunate that we are in the throes of a lot of witch hunting and finger pointing regarding the savings and loan bailout. Because not only at the House hearing did I hear a member wave the bloody shirt of the savings and loan industry, and indicate that this was a potential repeat of that, but on national television the Under Secretary of HUD suggested that this was another savings and loan bail out, and if that's what we wanted, then we should adopt Vento-Ridge. His response to the question of what he felt about Vento-Ridge is that we were going to have another savings and loan bailout.

And it almost reminds me of a physician who has a patient coming in with an inflamed toenail and because his prior patient had cancer, he wants to amputate the leg. That this environment is such that we want to overreact and get something done quickly so that everyone can look prudent. And they can look like they're being financially wise, and they want to do it rapidly so that we don't have this kind of situation.

This is not a savings and loan crisis. And I don't think we can relate the homeowners of America and their ability and willingness to repay the mortgages on the homes they own to people who operate and run savings and loans, and the kind of environment in which they were operating in and that which the consumers and users of the FHA are operating. And for us to liken that is demagoguery, and for us to wave that flag disallows us from honestly and openly discussing the issue.

And I, for one, have welcomed this opportunity to bring very very smart people and experts in this field to sit around the table and talk about the issue. Because I think some of the baseline issues did come to the forefront and did get some honest airing and did provide an opportunity which was devoid of some of that wide-eyed rhetoric that we've been listening to.

And I trust that the remaining time that the House deliberates on this issue and when the conferees meet, if we get to that, will be a time and environment where we can do this with both sensitivity and sensibility, being aware of the social thrust of the program and yet being very sensitive to the financial responsibilities and fiscal prudence we all must exercise.

Ms. CINCOTTA. Don.

Mr. CAMPBELL. Yes, Gail.

Ms. CINCOTTA. Before I have to run to the airport, too. What bothers me is we've talked so much about the fund and how big it should be and all that, and how it should be paid for. And we haven't spent enough time, I think, on how do we clean up the program an additional way as opposed to just having the mortgage and premium and cash, et cetera. And on some of these things, we've tried them on some of the organizations here who don't endorse the kinds of things you recommend. It's almost like, they don't want this but they don't want some of the cleanup also. And it bothers me that if we go another year, or another time before we do some cleanup, like I do think that HUD should not give the mortgage bankers more than 1 year for direct endorsements. I really think the whole question of direct endorsements should be looked at, and if that isn't the time in history that you could track

back to when the FHA mortgages were fast-tracked like that, that you did start to pick up the foreclosures.

But on the direct endorsements, I don't think they should be for more than a year. I think that HUD should have the right to suspend them even within that year, and to be able to see what's happening with different mortgage bankers, we've been proposing that there'd be a disclosure available on the default and foreclosure records by census tract, not by zip code, of the mortgage bankers. And that they also should keep track of what realtors they do business with.

If they're not going to self-police, if the real estate industry and the mortgage bankers are not going to self-police, then I think that Congress and HUD has got to do that. And Warren, you're smiling, but I remember a meeting with you where you said, it's HUD's job. You said that you do not believe and that we should have foreclosure made public to the public. That's what you said in New York.

Mr. LASKO. Right.

Ms. CINCOTTA. And I said, then, why don't you kick some of these people out of the MBA as a first step, because your associations are supposed to be, if you're good, you're part of those. And you said, you can't do that. And then you said, and by the way, there's a mortgage banker in our association that has over 40 percent foreclosure rating, what I remember your saying. And it was like incredible when I said, well, that's what public disclosure by census tract would help citizens take action on that, and you said, that HUD's job.

I mean, I think you all want to have it all your own way. Some of you have got to break ranks of saying, clean up the realtors; they're position and they're part of the problem. Clean up the mortgage bankers. Or give Staff to HUD. Give the citizens a disclosure data somewhere, but this has got to be over 25 years that I have been involved in dealing with FHA problems, neighborhood after neighborhood after neighborhood, and it just gets disgusting. Because the people who make money off the program are still the ones who fight every single kind of a reform. But anyway, I think disclosure helped us in the banking and the CRA, if you had public disclosure by census tract and there was a record kept of who does all these defaults. Maybe we have to help them police their folks. Maybe 95 percent of them are all right, but if they're not going to do it, then the citizens should do it.

The other piece that I think we're foolish in not spending the money ahead of time is on both prepurchase counseling, post-purchase, default counseling, that we really, for what it would cost, $300 or $400 to counsel a family, is just pennywise pound foolish of not spending that money, not appropriating, and even in some situations, making it mandatory. And I think, in the long run, maybe we wouldn't be discussing the depleted insurance fund, or the amount of abandoned buildings in all our neighborhoods, if we would really do some of those proactive ahead of time spending. And then maybe the figures will go down.

I would think the assignment program right now, because of the cutback in HUD staff from every legal assistance foundation lawyer I've talked to, it's not operating like it used to. And that kept people in their homes. And I would think also that, maybe not

for right now, but we ought to look into the question of how much does HUD's requirement that the mortgage banker has to convey them a building vacant creates people being put out in the street rather than, in the normal course of events, if an S&L or a bank foreclosed on me, you would stay there, the place would be sold, maybe everybody would get paid at least most of it, probably even the owner would make some money. But by having to put people out and convey the building occupied to HUD, I think is something we have never looked at, never at all even looked at how much difference could that have made in keeping, one, the fund viable, but keeping the buildings in the inventory and selling them person family to family, as opposed to vandalization that goes on with these homes.

So, somehow, if we could somehow deal with this and not only the fund, but the idea of how do we keep these folks in, and maybe if we had dealt with it year after year, we wouldn't be discussing a depleted insurance fund right now.

Mr. CAMPBELL. Well, Gail, the issues that you've identified have not been dealt with this year because of the crush of legislative work that has absorbed the committee's energies not because there's lack of interest in those issues. But with a little luck——

Ms. CINCOTTA. But it's every year, Don. It's every year.

Mr. CAMPBELL. I know. That's what I'm saying, with a little luck we will achieve enactment of the housing bill, and next year the attention of the committee can be focused more on oversight and on some of the ongoing problems that should be dealt with on a regular basis.

Yes, Mr. Seaton.

Mr. SEATON. Just a closing comment. I think the referral to the savings and loan business and the FSLIC insurance fund, as it relates to the FHA mutual mortgage insurance fund, I think only is in respect to the fact that there is a problem, that the fund is heading toward default and unlike the savings and loan fund, I hope we don't stand around and discuss it for several years before we decide to do something about it. And I think the Senate bill is a good first step. It may not be perfect and it may not be the full answer, but at least it's a start in addressing that problem.

Mr. CAMPBELL. Yes, Mr. Barmore.

Mr. BARMORE. I appreciate the opportunity to be here, and I'm going to have to excuse myself.

I would like to say, in parting, that there may be many ways to skin a cat, but the economic equivalent of what you've proposed is what's required for a long term healthy FHA. I think what we're talking about is how to skin the cat.

Mr. CAMPBELL. Right. Well, the details of skinning the cat will keep us busy from now until Congress adjourns, and that time is not far away. We're going to have to be spend a lot of time with you folks and others in your industries and with the administration to make sure that, as much as possible, this big decision will be based on solid analysis that will hold up over time. We appreciate your contributions today, of course, and we are looking forward to working with you in the weeks ahead.

Specifically, we need to make sure that we all are using accurate numbers, and we will need the support of Price Waterhouse and the experts in your organizations, as well.

Thank you very much.

[Whereupon, at 1:16 p.m., the committee was adjourned.]

STATEMENT OF THE
NATIONAL ASSOCIATION OF REALTORS®
BEFORE THE
SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS
OF THE
U.S. SENTATE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
BY
NORMAN D. FLYNN
PRESIDENT

July 24, 1990

INTRODUCTION

Mr. Chairman, my name is Norman D. Flynn. I am President of the NATIONAL ASSOCIATION OF REALTORS®. The NATIONAL ASSOCIATION OF REALTORS® has the largest membership of any trade association in the United States, with nearly 800,000 members representing all facets of the real estate industry including residential and commercial real estate development, mortgage banking, home building, property management, appraisals and syndication. On behalf of the members of the NATIONAL ASSOCIATION OF REALTORS®, I would like to thank you and the members of the Subcommittee on Housing and Urban Affairs for this opportunity to testify on the future viability of the Federal Housing Administration (FHA) program.

NAR is, first and foremost, totally committed to preserving the financial solvency and market viability of FHA. FHA is an essential vehicle for making affordable mortgage credit available to many home buyers across America who do not have the downpayment or other borrower profile to qualify for private mortgage insurance. I am particularly referring to low-to moderate-income borrowers, the majority of whom are first-time home buyers without sufficient savings to make the 10 percent or greater downpayments required by most private mortgage insurers.

HISTORICAL HOUSING MISSION OF FHA

FHA was created in 1934 in response to the lack of available mortgage insurance during the Great Depression. The goal of the FHA was to insure mortgage loans against default, which in turn would encourage lenders to make mortgage funds available to homebuyers. FHA ha- been a tremendous success! Since its creation, the FHA has helped over 17 million families purchase homes.

Today FHA is still urgently needed in order to continue providing assistance to potential homebuyers who would not be able to purchase homes without FHA programs. NAR survey data and reports by the Congressional Research Service (CRS) and other organizations demonstrate that the FHA program serves borrowers who have lower annual incomes, make smaller downpayments, and purchase lower value homes than homebuyers who utilize private mortgage insurance. A 1988 Harvard University Joint Center for Housing Studies report concluded that homeownership rates are continuing to decline. Married families with children and households from 25-34 years of age, significant FHA consumer groups, were among the primary groups with

Exhibit 1

State	Estimated # of Existing Home Sales 1988	Estimated # of FHA Loans on Existing Homes 1988	Percentage
ALABAMA	52600	7164	13.62%
ALASKA	9600	2475	25.78%
ARIZONA	64400	20683	32.12%
ARKANSAS	46600	7061	15.15%
CALIFORNIA	562800	63550	11.29%
COLORADO	49300	26153	53.05%
CONNECTICUT	57100	2543	4.45%
DELAWARE	13300	1104	8.30%
D. OF C.	10800	1358	12.57%
FLORIDA	183100	29315	16.01%
GEORGIA	84900	19226	22.65%
HAWAII	10300	2888	28.04%
IDAHO	11300	4943	43.74%
ILLINOIS	186500	26758	14.35%
INDIANA	85100	14696	17.27%
IOWA	54000	5048	9.35%
KANSAS	50600	6597	13.04%
KENTUCKY	67900	5394	7.94%
LOUISIANA	34500	9150	26.52%
MAINE	34200	985	2.88%
MARYLAND	86200	23649	27.44%
MASSACHUSETTS	93300	751	0.80%
MICHIGAN	168600	14836	8.80%
MINNESOTA	82400	21818	26.48%
MISSISSIPPI	30600	5024	16.42%
MISSOURI	83100	12924	15.55%
MONTANA	11900	3688	30.99%
NEBRASKA	22400	4604	20.55%
NEVADA	12200	6183	50.68%
NEW HAMPSHIRE	15300	196	1.28%
NEW JERSEY	142300	4591	3.23%
NEW MEXICO	18600	3712	19.96%
NEW YORK	213400	17143	8.03%
N. CAROLINA	141800	15488	10.92%
N. DAKOTA	11200	3028	27.04%
OHIO	181900	27398	15.06%
OKLAHOMA	49600	11112	22.40%
OREGON	53100	8202	15.45%
PENNSYLVANIA	276500	17923	6.48%
RHODE ISLAND	13800	201	1.46%
S. CAROLINA	63300	6210	9.81%
S. DAKOTA	14200	2222	15.65%
TENNESSEE	102600	18117	17.66%
TEXAS	238500	57769	24.22%
UTAH	14300	9519	66.57%
VERMONT	13400	254	1.90%
VIRGINIA	113600	24599	21.65%
WASHINGTON	48900	22193	45.38%
WEST VIRGINIA	44500	1322	2.97%
WISCONSIN	72200	4320	5.98%
WYOMING	5800	3077	53.05%
TOTAL	4108400	609164	14.83%

Exhibit 2

State	Estimated # of Existing Home Sales 1989	Estimated # of FHA Loans on Existing Homes 1989	Percentage
ALABAMA	51100	6744	13.20%
ALASKA	7100	2820	39.72%
ARIZONA	63400	17694	27.91%
ARKANSAS	47500	7444	15.67%
CALIFORNIA	538800	49125	9.12%
COLORADO	43800	25957	59.26%
CONNECTICUT	51400	2978	5.79%
DELAWARE	12800	867	6.77%
D. OF C.	9000	1158	12.87%
FLORIDA	185900	29416	15.82%
GEORGIA	82000	18920	23.07%
HAWAII	12100	1900	15.70%
IDAHO	13500	5244	38.84%
ILLINOIS	187900	25409	13.52%
INDIANA	87700	15072	17.19%
IOWA	52900	5560	10.51%
KANSAS	45100	7021	15.57%
KENTUCKY	70700	6297	8.91%
LOUISIANA	35400	9034	25.52%
MAINE	30400	1131	3.72%
MARYLAND	82000	19306	23.54%
MASSACHUSETTS	86500	1013	1.17%
MICHIGAN	178600	16407	9.19%
MINNESOTA	72800	21747	29.87%
MISSISSIPPI	31500	4982	15.82%
MISSOURI	83800	13789	16.45%
MONTANA	12700	3719	29.28%
NEBRASKA	24000	5299	22.08%
NEVADA	12900	5308	41.15%
NEW HAMPSHIRE	12700	345	2.72%
NEW JERSEY	128000	5337	4.17%
NEW MEXICO	19100	3517	18.41%
NEW YORK	198300	16055	8.10%
N. CAROLINA	132800	15311	11.53%
N. DAKOTA	11700	2661	22.74%
OHIO	189100	26375	13.95%
OKLAHOMA	53600	10122	18.88%
OREGON	59700	6560	10.99%
PENNSYLVANIA	242900	15893	6.54%
RHODE ISLAND	12900	1720	13.33%
S. CAROLINA	60200	6121	10.17%
S. DAKOTA	14400	1982	13.76%
TENNESSEE	105400	18082	17.16%
TEXAS	229300	52747	23.00%
UTAH	14400	8190	56.88%
VERMONT	11900	146	1.23%
VIRGINIA	100300	20445	20.38%
WASHINGTON	61100	17542	28.71%
WEST VIRGINIA	45900	1681	3.66%
WISCONSIN	70300	4148	5.90%
WYOMING	6000	3001	50.02%
TOTAL	3993300	569342	14.26%

declining homeownership rates. Without FHA, and unless the FHA mortgage insurance program is strengthened and expanded, many potential homebuyers will not be able to buy homes.

CURRENT MISSION OF FHA

The future of FHA is critically important to communities, states and the nation as a whole. On the state level, Exhibits 1 and 2 define the percentage of FHA loan transactions in every state in relation to the total amount of loan transactions in a state for the years 1988 and 1989. In both 1988 and 1989, FHA insured loans accounted for 15 percent or more of all loan transactions in thirty states. Similarly, in states such as: Alaska, Arizona, Colorado, Idaho, Louisiana, Minnesota, Nevada, Utah, Wyoming and Washington, FHA insured loans accounted for 25 percent or more of the total home loans transacted in both years. One in every four loans was FHA insured. Needless to say, the loss, or even decline of FHA's presence in those markets would be catastrophic.

An examination of FHA activity statistics nationwide reaffirms FHA's critical importance to all of us. In 1989, FHA insured loans represented 23 percent of all homes sold (again on a transaction basis). Over the last six years, FHA has accounted for more than 18 percent of all home sales transactions. While Exhibit 3 below measures the importance of FHA on a national basis, it is important to reiterate that the FHA program is of much greater importance to

Exhibit 3

FHA Activity
As a Percentage of Total Transactions

	Percent
1984	11%
1985	17
1986	22
1987	19
1988	18
1989	23
Average 1984-1989	18%

metropolitan areas. FHA activity is precluded from many market areas by the existing FHA maximum loan limits, and since FHA is involved in one out every five home sales on a national basis, it is clear that many local housing markets are crucially dependent upon FHA. Under HUD's proposed changes to FHA, these markets would suffer a catastrophic collapse in sales as well as significant erosion in house prices. Given FHA's current exposure in these markets, the HUD proposals would significantly weaken the financial viability of the MMIF because of the sharp increase in claims and losses from these collapsed housing markets.

Finally, FHA is no small player in the home insurance market, not only in terms of loans originated, but total dollar amount as well. For the information of the Subcommittee, we have enclosed a sheet (Exhibit 4) which breaks down the dollar volume of FHA business in every state for 1988, the last year for which complete nationwide statistics are available, in relation to the total dollar volume of mortgage loans transacted in that state. Keep in mind these figures are for

1988 FHA Market Share by State ($ In Millions)

Exhibit 4

States	FHA Loan $	Total Loan $	FHA As % Of Total
ALABAMA	424	3817	11.11%
ALASKA	187	799	23.40%
ARIZONA	1720	6696	25.69%
ARKANSAS	407	1838	22.14%
CALIFORNIA	6677	101031	6.61%
COLORADO	1770	5344	33.12%
CONNECTICUT	242	9373	2.58%
DELAWARE	84	843	9.96%
D. OF C.	103	1405	7.33%
FLORIDA	2492	19832	12.57%
GEORGIA	1355	7945	17.05%
HAWAII	498	3141	15.85%
IDAHO	258	1933	13.35%
ILLINOIS	1747	14417	12.12%
INDIANA	780	5760	13.54%
IOWA	213	1736	12.27%
KANSAS	336	2580	13.02%
KENTUCKY	263	3302	7.96%
LOUISIANA	588	3289	17.88%
MAINE	59	1599	3.69%
MARYLAND	2204	9959	22.13%
MASSACHUSETTS	56	13588	0.41%
MICHIGAN	606	7495	8.09%
MINNESOTA	1767	5592	31.60%
MISSISSIPPI	305	1954	15.61%
MISSOURI	725	5434	13.34%
MONTANA	200	661	30.26%
NEBRASKA	228	1189	19.18%
NEVADA	628	2045	30.71%
NEW HAMPSHIRE	14	2079	0.67%
NEW JERSEY	304	16935	1.80%
NEW MEXICO	328	2088	15.71%
NEW YORK	1087	24884	4.37%
N. CAROLINA	1017	8540	11.91%
N. DAKOTA	139	475	29.26%
OHIO	1352	12358	10.94%
OKLAHOMA	612	2238	27.35%
OREGON	497	2019	24.62%
PENNSYLVANIA	901	12249	7.36%
RHODE ISLAND	11	2195	0.50%
S. CAROLINA	348	3573	9.74%
S. DAKOTA	115	488	23.57%
TENNESSEE	1081	5321	20.32%
TEXAS	3901	14694	26.55%
UTAH	654	2156	30.33%
VERMONT	15	772	1.94%
VIRGINIA	2003	13972	14.34%
WASHINGTON	1540	8558	17.99%
WEST VIRGINIA	61	1156	5.28%
WISCONSIN	204	4671	4.37%
WYOMING	162	472	34.32%
PUERTO RICO	526	1330	39.55%
VIRGIN ISLANDS	0	8	0.00%
GUAM	1	29	3.45%
TOTALS	43795	387857	11.29%

dollar volume, not number of mortgages, and FHA operates under a maximum mortgage insurance ceiling, adjusted annually, that inherently keeps dollar volume down. Even with these numbers, FHA accounts for over 20 percent or more of the total dollar volume of loans in eighteen states. Many of these states (Texas, Colorado, Oklahoma, Alaska) are in regions that have been experiencing severe economic problems. As a result, private mortgage insurers' involvement in these markets is minimal, leaving FHA as the only viable home insurer left in town. Any attempts to promote and encourage homeownership must recognize the important role that the FHA has played and can continue to play in our nation's mortgage finance system.

PURPOSE

Originally, NAR thought we would have the opportuntiy to present our analysis of the recently completed Price Waterhouse study on the actuarial soundness of the FHA program. This analysis of the Price Waterhouse report would have included an examination of the research methodology employed, the findings of the study and various alternatives recommended for resolving the current financial situation of the fund. However, this examination process has been preempted by sudden haste to find a legislative solution to the problem. After only a single hearing with HUD Secretary Kemp and the auditors from Price Waterhouse, the U.S. Senate accepted major changes in the FHA program into the housing bill, the National Affordable Housing Act, which passed the Senate on June 27, 1990. The FHA provisions, which the Senate adopted, correlate very closely to the FHA changes initially recommended by Secretary Kemp in his testimony before the Senate Banking Committee.

Given this action, it is more useful to direct the emphasis away from examining the mechanics of the Price Waterhouse report to addressing the various legislative solutions and discuss NAR's own recommendations for restoring financial soundness to the FHA fund.

SENATE PROPOSAL

NAR believes the Senate approved FHA changes which are similar, if not identical, to what HUD has recommended are fundamentally flawed even though they too would restore FHA to a sound financial basis. The Senate approved FHA changes and those proposed by HUD would have a drastically negative impact on the current operation of FHA. FHA's basic mission of making affordable mortgage credit available to home buyers across America would be severely jeopardized under the terms of their proposals. NAR estimates 100,000 families annually would be disqualified from participating in FHA under these changes. Most of these families would come from the lower income borrowers who have great difficulty obtaining the up-front cash required to cover all the transaction and downpayment costs associated with the purchase of a home and are therefore unable to obtain private mortgage insurance.

Over the last several weeks, REALTORS® from every part of the country have expressed their real fear that this legislative action by the Senate and the proposals recommended by HUD will severely restrict the use of FHA and deal a severe blow to the availability of affordable housing in their communities. I believe their fears are well founded especially given those provisions relating to the restructuring of the mortgage insurance premium (MIP), the creation of a risk-based premium surcharge and HUD's recommendation on restricting the financing of closing costs.

A) Restructuring of the MIP Premium

Under the FHA language adopted by the Senate, in addition to the current 3.8 percent mortgage insurance premium paid up-front, borrowers would be required to pay a monthly risk-based premium surcharge of 0.5 percent to extend over the life of the loan in proportion to their level of loan-to-value (LTV) ratio. The higher the LTV number, the more years they pay a premium.

- less than 5 percent down, additional .5 percent premium is paid for 15 years;
- 5 percent to 7 percent down, additional .5 percent premium is paid for 10 years;
- 7 percent to 10 percent down, additional .5 percent premium is paid for 4 years;
- more than 10 percent down, there would be no additional premium.

This initial 3.8 percent MIP, which is all that current law requires, could still be financed. The whole structuring of this mortgage insurance premium relates to the budget gimmickry measures enacted back in 1982. Prior to 1982, the FHA insurance premium was collected on a "pay-as-you-go" basis. In September of 1983 as part of the Budget Reconciliation Act, this policy was changed to a 3.8 percent up-front payment which was allowed to be financed into the FHA mortgage so as to minimize what would otherwise have been an extraordinary negative impact to the borrower. The reasons for this policy change had nothing to do with helping homebuyers; it was a form of budgetary "smoke and mirrors" to give the illusion of reducing the size of the federal deficit. The situation with FHA is identical to that of the Treasury using the Social Security Trust Fund in an attempt to mask the true size of the deficit. But this "budget gimmick" has had a serious negative impact on the financial health of the FHA fund.

B) Change to Risk-Based Premiums

The critical factor in the Senate-passed provision is the alteration of the fundamental operating premise of FHA. Currently, the less risky FHA borrower (i.e. lower LTV loans, stronger economic regions etc.) cross-subsidizes the riskier FHA borrower who has less downpayment or is purchasing a home in an economically distressed area. This cross subsidy is eliminated under the HUD and Senate proposal.

Further, once the premise of risk-based premiums is established, it will open the door to the implementation of even more controversial methods including regional underwriting, a concept HUD has been publicly exploring with various industry and legislative groups. Home buyers in economically distressed areas could be assessed higher premiums to offset the riskier economic market of that region. Or, as an alternative, FHA activity in distressed areas such as many southwestern and western states, states such as: Texas, Colorado, Oklahoma and Alaska would be severely curtailed.

To best understand how the implementation of risk-based premiums will adversely affect the future of FHA, you must carefully examine the contents of the Price Waterhouse Study. The principal Price Waterhouse assumption underlying the Administration's proposal is the belief that risk-based premiums will eliminate adverse selection to the FHA program. Price Waterhouse states that the current structure of the FHA mortgage insurance program creates a situation where the riskiest homebuyers select FHA over the conventional mortgage market. This occurs in two ways: 1) those potential homebuyers who have little savings and cannot qualify for a loan

in the conventional market select FHA; and 2) those homebuyers who do have savings select FHA and put down the bare minimum as required by FHA guidelines.

Price Waterhouse contends this second group, when faced by the choice of higher premiums over time versus putting more down at settlement, will opt to make a larger downpayment to reduce their future monthly outlays. The first group is the segment of current FHA homebuyers who Price Waterhouse has determined will "have to wait longer to purchase a home due to the increased cash needed at closing," i.e., this group will be denied FHA mortgage insurance. Requiring more from the already lower risk group and denying mortgage insurance to the highest risk group will change the level of risk entering the FHA "book of business" in future years. Unfortunately, the Price Waterhouse analysis did not include a market analysis of this premise, for example, will the lower risk group pay more or opt to insure their home purchase through the conventional market?

Price Waterhouse's assumption here is that home buyers will respond to the "real" cost of buying a home, and not the "nominal" cost. Economic research into consumer responses to increases in costs on durable goods indicates that consumers are much more responsive to changes in nominal prices, not real prices. NAR firmly believes that the lower risk home buyer, who is currently selecting to use the FHA mortgage insurance program, will respond to the increased cash requirements under the HUD proposal by making a price comparison between FHA and private mortgage insurance industry. We believe they will then elect to leave the FHA mortgage insurance program; not, as assumed by Price Waterhouse, simply pay significantly more out-of-pocket cash at closing to avoid a slight increase in mortgage payments over time.

The loss of low risk homebuyers from the FHA Mutual Mortgage Insurance program has not been modeled by Price Waterhouse. NAR believes that the HUD proposals will effectively gut the MMIF by eliminating the current level of cross subsidization by the low risk homebuyers, and will result in introducing more, not less, risk into all future FHA "books of business". We are particularly troubled by the lack of any empirical testing of the adverse risk assumption by Price Waterhouse. The FHA single-family mortgage insurance program is so crucial to the well being of so many individual markets that it is simply irresponsible social policy to make such significant program changes nationally with no real world testing of how consumers will respond to the change in cost to acquire FHA mortgage insurance.

C) Restrictions on Financing the Closing Costs

Under the slogan of improving borrower home equity, HUD has advocated that borrowers be required to provide two-thirds of the necessary cash up-front to cover closing costs with one-third still eligible for financing. On the average home this means an additional $1,400 up-front cash out-of-pocket. This additional cost is being portrayed as providing for greater borrower equity in their home. Frankly, the connection between cash up-front for transaction fees, which are essentially all that closing costs cover: lawyers, title, etc. and greater borrower equity is a tenuous argument at best.

No one disputes the fact that the inability to come up with the cash needed to cover downpayment and closing costs on a home is, without a doubt, the single greatest barrier keeping tens of thousands of Americans from purchasing a home. The Administration's proposal makes the situation even worse. It turns a barrier into a blockade.

Fundamentally, the HUD and Senate FHA proposals are budget driven, rather than housing driven. It is clear that the Senate and the Administration intend to place the obligation of restoring the safety and soundness of FHA squarely on the backs of the lower-end borrowers.

REALTOR® RECOMMENDATIONS

Absolutely, changes in FHA are needed, but not at the expense of the future home buyers of America who need FHA to buy their homes. The Price Waterhouse study of FHA provides a number of options, from which alternatives have been developed which both rebuild the equity of FHA and keep homeownership available for potential FHA families.

NAR is unequivocally committed to preserving the financial solvency of FHA while safeguarding the original congressional intent of providing affordable mortgage credit to tens of thousands of low-to moderate-income home buyers across America. FHA must serve both purposes or it ceases to serve any purpose. Thus, we offer these principles for saving FHA which we believe more responsibly balance the safety and soundness needs of FHA with the congressionally mandated housing mission of FHA.

1) Restructure the mortgage insurance premium to a pay-as-you go system which worked effectively prior to 1982. This would include a small up-front premium, which could be financed, with an annual premium that would be set to meet actuarial standards.

2) Reach actuarial soundness in accordance with the Price Waterhouse requirements (1.25 percent equity over the short term and greater equity over the longer term).

3) Maintain current down payment requirements and financing of closing costs. Within a specified period, no FHA loan would exceed 100 percent LTV. This would be superior to the Senate or Administration versions in which loans in excess of 100 percent real LTV would continue to be insured in order to mask federal deficit problems.

4) Discontinue paying distributive shares until the fund has attained actuarial soundness.

5) Minimize the adverse impact that FHA restructuring will have on the lower-end borrowers and their access to affordable mortgage credit while maintaining the future safety and soundness of FHA operations.

VENTO/RIDGE AMENDMENT

NAR supports the proposal offered by Congressman Bruce Vento (D-MN) and Congressman Tom Ridge (R-PA) which we believe best accomplishes the five main objectives that all would agree are essential to the future viability of FHA. This proposal builds on the fundamentally sound goals of returning to what works and protecting the FHA families from shouldering unfair burdens.

Under the Vento/Ridge legislation, FHA returns to a pay-as-you-go system. After a phase-in period, FHA borrowers would eventually be required to pay a 1.35 percent up-front premium, which could be financed, and a .6 percent annual premium. It is important to remember that the closing costs can continue to be financed. The Vento/Ridge proposal would

Exhibit 5

LOAN FINANCING ANALYSIS OF VARIOUS FHA OPTIONS

	CURRENT LAW	HUD PROPOSAL	VENTO/ RIDGE (1st Year)	VENTO/ RIDGE (3rd Year)	VENTO/ RIDGE (After phase in)
A. Selling Price	$ 65,000	$ 65,000	$ 65,000	$ 65,000	$ 65,000
B. Financable Closing Costs*	1,300	433	1,300	1,300	1,300
C. Acquisition Cost	66,300	65,433	66,300	66,300	66,300
D. Downpayment	2,815	2,772	2,815	2,815	2,815
(Non-financable closing costs)	0	867	0	0	0
E. Loan Amount Before MIP	63,485	62,661	63,485	63,485	63,485
F. MIP	2,412	2,381	2,381	1,365	857
G. Total Financed	65,897	65,042	65,866	64,850	64,342
H. FHA LTV***	95.75%	95.76%	95.75%	95.75%	95.75%
I. True LTV****	101.38	100.06	101.33	99.77	98.99
J. Initial Cash Required	$ 2,815	$ 3,639	$ 2,815	$ 2,815	$ 2,815
K. Additional Closing Costs** (Loan Origination & Escrow)	1,300	1,300	1,300	1,300	1,300
L. Up-front Cash Required of Borrower	4,115	4,939	4,115	4,115	4,115

* HUD allows up to 3% of selling price; assumes 2% based on historical data.

** One discount point for loan and one point for prepaid escrow (currently cannot be financed). (Total closing costs of 4%)

*** Loan Amount Before MIP amount divided by Acquisition Cost (Line E divided by Line C)

**** Total Financed divided by Selling Price (Line G divided by Line A) (This is true loan-to-value as used by Price Waterhouse Report, p. 19)

Note: PMI case represents typical PMI pricing of 95% LTV mortgage assumes 1.25% premium at settlement.

Exhibit 6

LOAN FINANCING ANALYSIS OF VARIOUS FHA OPTIONS

	CURRENT LAW	HUD PROPOSAL	VENTO/ RIDGE (1st Year)	VENTO/ RIDGE (3rd Year)	VENTO/ RIDGE (After phase in)
A. Selling Price	$100,000	$100,000	$100,000	$100,000	$100,000
B. Financable Closing Costs*	2,000	667	2,000	2,000	2,000
C. Acquisition Cost	102,000	100,667	102,000	102,000	102,000
D. Downpayment	4,600	4,533	4,600	4,600	4,600
(Non-financable closing costs)	0	1,333	0	0	0
E. Loan Amount Before MIP	97,400	96,134	97,400	97,400	97,400
F. MIP	3,701	3,653	3,653	2,094	1,315
G. Total Financed	101,101	99,787	101,053	99,494	98,715
H. FHA LTV***	95.5%	95.5%	95.5%	95.5%	95.5%
I. True LTV****	101.1	99.79	101.05	99.49	98.72
J. Initial Cash Required	$ 4,600	$ 5,866	$ 4,600	$ 4,600	$ 4,600
K. Additional Closing Costs**	2,000	2,000	2,000	2,000	2,000
L. Up-front Cash Required of Borrower	6,600	7,866	6,600	6,600	6,600

* HUD allows up to 3% of selling price; assumes 2% based on historical data.

** One discount point for loan and one point for prepaid escrow (currently cannot be financed). (Total closing costs of 4%)

*** Loan Amount Before MIP amount divided by Acquisition Cost (Line E divided by Line C)

**** Total Financed divided by Selling Price (Line G divided by Line A) (This is true loan-to-value as used by Price Waterhouse Report, p. 19)

Note: PMI case represents typical PMI pricing of 95% LTV mortgage assumes 1.25% premium at settlement.

hold down out-of-pocket borrower cash requirements while achieving an even better LTV then the Administration's proposal achieves, thus preserving sufficient protection against default risk. The protection from default risk is realized through the 1.35 percent premium up-front, which could be financed, but non-refundable. This non-refundable aspect is very important, because it allows the MMIF to immediately recognize this money as earned premiums. This improves the reserve position of the Fund while eliminating the need for future refunds if an FHA home buyer prepays in the initial years of the mortgage as is the current practice of the Fund. This current practice is necessary because the Fund collects the entire premium up-front and holds it in escrow. Vento/Ridge recognizes the premium as it is earned against the actual risk of carrying a loan on the books.

Exhibits 5 and 6 present two typical FHA scenarios, one with a sales price of $65,000 and the other $100,000, as a means of demonstrating how the Vento/Ridge proposal compares to current FHA requirements and the Administration's FHA proposal which in essence was adopted by the Senate. Presented for the current FHA program, and the various alternative proposals are the following:

- Sales Price
- Financeable Closing Costs
- Total Acquisition Cost
- Minimum Downpayment
- Loan Amount before MIP
- MIP
- Total Amount Financed
- FHA LTV
- True LTV
- Initial Cash Required
- Additional Closing Costs
- Total Up-front Cash Required of Borrowers at Settlement

Exhibit 5 presents a typical $65,000 home sales transaction. Under current law, a home buyer who opts for FHA mortgage insurance would finance approximately $1,300 in allowable closing costs in their mortgage, resulting in a total acquisition cost on this transaction of $66,300. The minimum downpayment required under current rules is $2,815, resulting in a loan amount before MIP of $63,485. The MIP is 3.8 percent of this amount, or $2,412 which is assumed to be financed in the loan. Total financed under current law would be $65,897. A true LTV on this transaction is 101.38 percent of the original sales price. As FHA calculates LTV (excludes the MIP premium from the calculation and uses the total acquisition cost as the base), this transaction has an LTV of 95.75 percent.

The amount of out-of-pocket cash required of the FHA borrower is the sum of the minimum downpayment (initial cash required) plus those closing costs explicitly disallowed from financing (e.g., discount points, escrow accounts or pre-paid accounts, etc.). For this transaction, the up-front cash required is $4,115. This amount includes the minimum downpayment requirement of $2,815 and $1,300 in non-allowable closing costs. This is the baseline to which we compare the various other options.

The HUD proposal, by comparison, would result in a higher up-front cash requirement of borrowers. Based on the same $65,000 sales price, two thirds of the formerly "allowable" closing costs must now be paid in cash at settlement. Of the $1,300 of closing costs which were formerly

financed, only $433 can now be financed. For this proposal, the total acquisition cost is $65,433, and the minimum downpayment is $2,772. The loan amount before MIP is $62,661. The MIP is 3.8 percent of this amount or $2,381. The total amount financed is $65,042, resulting in a true LTV of 100.06 percent and an FHA LTV of 95.76 percent. Initial cash required is the sum of two components -- the $2,772 minimum downpayment plus the disallowed two-thirds of closing costs of $867 -- or $3,639. After adding the additional closing costs which also can not be financed ($1,300), the up-front cash requirement for borrowers under this proposal is $4,939, a 20 percent increase in out-of-pocket expense at closing as compared to the baseline of current law.

Under the Vento/Ridge proposal, the up-front cash required at settlement would be the same as under the baseline, or $4115. This will hold true during and after the phase-in to a 1.35 percent up-front premium in the sixth year. The sales price, allowable closing costs, total acquisition cost, minimum down payment and loan amount before the MIP is identical to the baseline during the phase-in period. The MIP required up-front declines from $2,381 in year one to $1,365 in year three and finally to $857 after the phase-in. The total amount financed in years one through the phase-in is $65,866 in year one, $64,850 in year three and $64,342 after the phase-in. The FHA LTV for all the years is the same as the baseline -- 95.75 percent. The true LTV declines from 101.33 percent in year one to 98.99 percent after the phase-in.

Exhibit 6 presents the same comparisons for a $100,000 sales transaction. The HUD proposal would require more cash up-front at settlement than would current law or the Vento-Ridge proposal. The HUD proposal would increase up-front cash by 19 percent. The Vento-Ridge proposal would not increase out-of-pocket costs to FHA homebuyers.

RAISING THE FHA MAXIMUM MORTGAGE LIMIT

I would not like to leave a discussion of FHA changes without reiterating NAR's long standing position on raising the FHA mortgage loan limits. NAR believes the maximum amount of principal the FHA is allowed to insure should be raised to keep pace with home price appreciation. NAR would support indexing the FHA mortgage ceiling to 95 percent of the median price of housing in each area with a national ceiling of 85 percent of the Fannie Mae and Freddie Mac conforming loan limits; in conjunction with this, we would also support establishing a minimum downpayment requirement of 3 percent of the first $25,000 of the loan amount, 5 percent of the loan amount between $25,000 and $125,000 and 10 percent of the amount over $125,000. The 10 percent marginal downpayment requirement would assure the quality of large loans in high-cost areas.

In our estimation, Raising the maximum mortgage limit and increasing the downpayment requirements will improve the financial position of the MMIF and reduce the likelihood that the MMIF will show net outlays in the future. Raising the mortgage limit will improve the financial position of the MMIF by broadening the usage of the program in terms of serving borrowers in more areas and also in terms of the range of borrowers who would buy homes that could qualify under the program. Consequently, FHA will be able to obtain a more diversified portfolio of loans to minimize risk.

As discussed above, the FHA has been effectively providing American homebuyers with access to financial capital for home buying for many years, enabling millions of homebuyers to obtain mortgages. However, FHA maximum mortgage limits have not kept pace with increases in home prices in many areas. Consequently, FHA loan limits no longer reflect the costs of homes in certain areas.

This problem can be examined by comparing the increase in the median sales price of existing single family homes to the rise in FHA loan limits over time. During 1940, FHA loan limits were close to five times higher than the median sales price of an existing single family home. By 1960, FHA loan limits were only about one-and-one-third higher than median sales prices. Finally, in 1989 FHA loan limits had fallen to 109 percent of the median price of an existing home. Thus, because current housing costs are substantially higher than the existing FHA limit, homeownership is put out of reach for many borrowers who cannot qualify for conventional financing.

The current statutory maximum mortgage limit is $124,875, which is not high enough to purchase a median priced home in many metropolitan statistical areas in this country. In these areas, the loan limit is constraining the ability of moderate income homebuyers to obtain financing for home purchases. For instance, the FHA maximum limit applies to most of California, much of New York and Maryland, and areas of Texas and Nevada. HUD has set the limit at the maximum for three entire states -- Massachusetts, Connecticut, and Rhode Island. A illustration of the resulting situation can be seen in Exhibit 7 which shows how consistently small FHA's book of business is in designated high cost states.

Exhibit 7

FHA ACTIVITY IN HIGH COST STATES

	1987	1988	1989	Median Sales Price	Current FHA Limit
California	21.21%	6.61%	9.12%	$ 173,500	$ 124,875
Connecticut	2.85%	4.45%	5.79%	$ 165,000	$ 124,875
Massachusetts	.81%	.80%	1.17%	$ 150,000	$ 124,875
Rhode Island	2.22%	1.46%	13.33%	$ 133,500	$ 124,875

CONCLUSION

In summary, Mr. Chairman and members of the Subcommittee, there is a vital need in our Nation, states and communities for an economically vibrant, financially sound FHA program that continues to make affordable mortgage credit available to those lower income and first-time home buyers dependent on FHA to fulfill their dream of homeownership. We must not lock them out! Thus, we ask for your consideration of alternative proposals to improve the FHA as you begin conference with the House on a housing bill. Thank you again for this opportunity to testify before this Subcommittee.

TECHNICAL APPENDIX

ANALYSIS OF THE PRICE WATERHOUSE CONDITIONAL CLAIM RATE MODEL

Price Waterhouse's Approach and Methodology

The Price Waterhouse (PW) approach to predicting the number of claim terminations is to build a statistical model to forecast future conditional claim rates. They use annual data on default (foreclosure) claims from loans originated in 1975 through 1987, with defaults occurring from 1975 through 1989. This time span covers a period where home prices were rapidly rising (late 1970s), then falling (early 1980s), and default rates were relatively low in the late 1970s early 1980s. However, defaults substantially increased due to mismanagement, fraud, and abuse in the mid- to late-1980s. Thus, the historical time period chosen forms an inherent path of five to seven years of low defaults and seven later years of high defaults.

Individual statistical equations are separately fit for six loan-to-value ratio (LTV) classes. Each statistical equation was constructed from 12 origination years with a sequence of annual claim rates declining by one per year. The basic dependent (predicted) variable is the ratio of the annual number of defaults in the period to the beginning of the year survivors for a group (cohort) of mortgages originated in a specified year (1975-1987). For a specified cohort there results a series of up to 14 default rates (14 years), representing the likelihood that a mortgage in a specified cohort would enter default so many years hence, given that it has not defaulted up to that year.

Thus, while each cohort can be thought of as representing a unique historical organism; many of the cohorts are similar in basic underwriting characteristics and their default rates are impacted by the same historical economic conditions. In this sense, although there is a large sample there are many overlaps across independent variables. Consequently, the generalizability of these results to future cohorts is limited.

Weaknesses in the Econometric Methodology

The PW analysts weighted the data by the number of survivors in each period. This is the most simplistic possible econometric application of a more general form of least squares to attempt to control for possible non-constant variance in the residual across cohorts. However, they needed to test each cohort time-series to see whether the cohorts could be pooled and to estimate the residual variance across the cohort before pooling. We have recommended to PW that they also test for grouping of the LTV classes in a single model using the seemingly unrelated regression equation (SURE) approach to further reduce the error variance, and also allow for explicit testing of the significance of variables across LTV classes. This should be done and, in this sense, we feel the econometric specification was not completely explored.

While PW has obtained good cumulative explanatory power (percent of total actual claims explained), the true test of the model is to see whether it can predict claims on a year-by-year basis. The model needs to be evaluated for each policy year for each cohort to see how and when it is over and under predicting. PW did not perform such an period analysis and this is the standard test for an econometric model, carried out by most thorough researchers.

An important weakness of the study is that, of the 21 independent variables in the equation, 13 are merely policy year "dummy" variables that indicate the year after origination corresponding to

a cohort's claim rate, merely tracing a "time path" as opposed to providing an explanation for the claim. Our own statistical analyses using the same database, but not broken out by mortgage class or LTV, show that a full 50 percent of the variance in the dependent variable can be explained with 10 to 15 policy year variables. Thus, they are just using past history to predict. A single time-from-origination variable should have been used instead.

Furthermore, in our model unemployment rate is significant and so is average annual home price appreciation rates. These help boost the fit to 60 to 70 percent based on a sample of 172 observations. It is not a small wonder that in the PW model, the 728 pooled observations yield fits that are slightly larger.

Analysis of Predictor Variables in the Claim Rate Model

Although the policy year variables fit past history well, the best future prediction needs to be based on measurable characteristics of the insured mortgagors. Prior "micro" data based study variables included individual borrower and mortgage characteristics such as occupation classes, income, LTV, payment-to-income ratio, martial status, and use of secondary financing. These studies usually obtained fits of only 20 to 40 percent. Time-series based studies used income and LTV classes with a single time-trend index to forecast into the future. They obtained fits of 40 to 60 percent. Thus, the good fits obtained by PW are based primarily on the multiple history-dependent policy year dummies, not on the variables most directly related to the characteristics of mortgage, or borrowers, or economic factors affecting borrowers'ability to pay their mortgage. In this sense much of the correlation is " spurious" and will not be useful to predict future defaults.

Furthermore, there are only three economic or behavioral types of predictor variables used in the claim rate model: the unemployment rate; an equity index which is used in a number of ways; and a house price dispersion index. The strengths and weaknesses of these, as predictive factors, are discussed below.

Unemployment rate: The unemployment rate variable is lagged one period to measure the impact of prior loss of job on default rates. The results for this variable seem intuitive and reasonable.

Equity Variables: The statistical model utilizes a number of equity variables cross-classified by time period as well as by mortgage amount. The equity variables were derived from a time-series index by making a number of critical assumptions about financial behavior when interest rates change, and using a discount factor based on the Bureau of Labor Statistics (BLS) constant quality price index. The equity index is manipulated to devise a time-series relationship involving the original LTV, premium refund value (over time), the discounted value of amortized mortgage payments, and the rate of change of the constant quality price index.

The weakness in this index is that when interest rates fall, measured equity value decreases. This seems to contradict most historical experience that when interest rates decline home prices, and therefore equity, tend to increase. PW's theory is that the mortgage is like a bond and decreases in interest rates raise the value of the mortgage causing borrower equity to decline. This view erroneously focuses more on financial investor behavior, assuming homebuyers revaluate their "option" to pay-off

the mortgage like Wall Street financiers. We seriously doubt most FHA borrowers think or act based on this type of theory.

The PW model uses several types of equity measurements. While many of these results have statistical significance, there does not seem to be a strong theoretical reason for these additional specifications and they seem to be there only to superficially bolster the statistical fit. We also believe the text of the PW report is not sufficiently explicit in its theoretical justification for these specifications.

House Price Dispersion: The constant quality price index was used in the equity index. The Price Waterhouse analysts also created a variable to measure the house price variation over time across regions to proxy for the problems of price declines in certain areas with simultaneous increases in others. The same index was disaggregated by the four census regions. At the margin, this index is the largest contributor to the claim rate of any of the variables. The form of the variable is that of a variational measure using the standard deviation of the regional percentage changes deflated by 1 plus the national price change in the index. However, the four census regions are considerably too large for accurate measurement of any state or metropolitan area impacts. Moreover, if the variable reflected U.S. regional economic disparities, the index values would be larger and the estimated coefficients would be smaller. Thus, it would lead to lower claims rates and probably decrease statistical significance.

There is also the question of using the constant quality price index in the equity variables and the price dispersion variable. While these are statistically significant. the model seems to rely too heavily on the constant quality price index. We know price changes have been a major factor in housing markets in the late 1970s and early 1980s; however, we do not know what will happen in the 1990s and early 21st century. Most analysts see a decline in real estate price pressures with the aging of the population. Thus, price changes will probably be a poor predictor of default behavior.

Finally, we feel the decision to use the older constant quality price index, which yielded larger MMI Fund losses than the most recent index ignored the best available information. Price Waterhouse justified their use of the previous index values based on "familiarity" and experience with the data series. However, most analysts prefer to use the most recent data available. Consequently, we cannot understand why the fuily analyzed results in Appendix D were not put forth as the official accepted results.

Additional Conclusions

The Price Waterhouse claim rate model also has the following deficiencies:

- It ignores major restrictive underwriting changes instituted during and after 1985.
- The model is adversely affected by the database's inability to identify individual loans as investor loans or refinancing.
- The end results of these problems are that the Price Waterhouse model tends to:
  - slightly underestimate FHA losses from pre-1986 originations,

- overestimates the losses on 1986-1989 originations (their estimated ultimate claim rate
on future business is around 12. 5% versus the HUD estimate of at most 10%), and

- overestimates the losses on future FHA business.

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**Statement of Gregory T. Barmore President,
Mortgage Insurance Companies of America
Before the Senate Subcommittee on Housing and Urban Affairs**

July 24, 1990

Mr. Chairman and Members of the Subcommittee:

The Mortgage Insurance Companies of America (MICA) appreciates the opportunity to testify before this subcommittee. We are concerned with the financial soundness of the Federal Housing Administration's single-family mortgage insurance program (FHA). FHA plays an important role in housing America. MICA believes our nation needs a strong, viable FHA program designed to serve low- and moderate-income homebuyers. To operate in today's environment, FHA must find a balance between its social role and its financial responsibilities.

MICA's testimony today will outline some of the problems the industry sees with FHA and then highlight some solutions to FHA's problems. MICA fully supports the reforms to FHA that the Senate enacted in S. 566. If FHA is going to continue to serve average working Americans, it must be put back on financially sound ground.

FHA's Financial Soundness

Unfortunately recent evidence reveals that the Mutual Mortgage Insurance Fund (MMIF), which supports the single-family mortgage insurance program, is in deep financial trouble. In fact, its condition has deteriorated in a surprisingly short period of time. We knew that the MMIF was losing money. Indeed, our industry paid over $5 billion in claims in the past five years. However, in recent years, we have been able to adapt to the changed nature of home mortgage default risk. We believe that FHA now must implement changes to its single-family program to return to a sound, self-sustaining insurance fund.

The Price Waterhouse actuarial study on the financial condition of FHA concluded that the continuation of present FHA policies "will eventually lead to insolvency because new business written under existing policies is unsound." The study stated that "it is crucial that new business be put on a sound footing as soon

as possible." In fact, during the 1980's the MMIF's capital eroded from 5.3 percent to 1 percent of insurance in force. With $300 billion of insurance in force the MMIF only has $2.6 billion of capital. Price Waterhouse proposes minimum capital requirements of 1.25 percent of insurance in force, which is set so that the fund could withstand a slight economic recession. This compares to private mortgage insurers which are required to maintain capital of about four percent of risk in force. By the end of 1990, the MMIF will be $1.35 billion below the minimum capital Price Waterhouse calculates is required.

The numbers become more troubling when it is noted that the Price Waterhouse study bases its forecast for FHA on the fact that home prices will appreciate at a rate of 3.25 percent a year on a constant quality basis. If homes do not appreciate at that rate then Price Waterhouse states that the losses for FHA will be far greater. Two Harvard University economists recently concluded that real house prices (prices adjusted for inflation) will decline by three percent a year for the next two decades. These economists predict that by the year 2007 real housing prices will be 47 percent lower than current prices. In addition, Robert Van Order, chief economist for Freddie Mac, forecasts a decline of 23 percent in real housing values over the next two decades. If either of these scenarios are true FHA, taxpayers and homebuyers will bear a burden far more serious than any of the forecast contained in the Price Waterhouse report. In fact, Price Waterhouse concluded that if home prices only appreciate at a rate of 2.5 percent per year, the MMIF's capital will fall by an additional $2.35 billion by the end of 1990.

The Federal government effectively is gambling on home price appreciation. Price Waterhouse pointed out that if homes only appreciate at a rate of 3.25 percent a year then FHA's new business will lose $200 million a year. If home prices appreciate at a rate of 2.5 percent a year on a constant quality basis, then FHA's new business will lose $667 million and if home prices appreciate at a rate of 1.25 percent a year on a constant quality basis, then FHA's new business will lose $876 million.

In human terms, these numbers mean that the American taxpayers could face another multi-billion dollar bailout of a Federal program, unless FHA is restructured now. They also illustrate the fact that the way the FHA program presently operates causes tens of thousands of foreclosures every year. Families are put into homes, only to ultimately lose them because they cannot afford their payments.

Restructuring FHA

MICA applauds the Administration and the bipartisan effort in the Senate to restructure FHA. The legislation to reform FHA recently passed by the Senate (S. 566) was based on recommendations in the Price Waterhouse study. They address three key issues -- adequate downpayment, adequate premiums, and appropriate loan limits. The recommendations are excellent steps toward restoring FHA's financial health, while balancing FHA's social role.

Adequate Downpayment. The Price Waterhouse study identified the amount of downpayment as a key determinant of default. The study concludes that "higher downpayments (lower loan-to-value ratios) result in a lower default rate." "The FHA experience indicates that borrowers have higher likelihood of default and foreclosure as the loan-to-value ratio increases with the effect accelerating when the loan-to-value ratio moves to about 90 percent." According to a study by the National Association of Realtors, the average FHA loan-to-value has been increasing, rising from 85.4 in 1984 to 94.7 in 1988.

The importance of downpayment was the subject of many earlier studies. For example, a May 1989 study by the Government Accounting Office (GAO) found that claim rates for FHA loans are as much as three to four times greater for loans with a three percent downpayment compared with those loans made with a 10 percent downpayment. Private mortgage insurance industry data also shows that the default rate for 95 percent loan-to-value ratio loans is almost double the default rate of 90 percent loan-to-value ratio loans. (See Appendix I)

S. 566 requires that borrowers have at least two percent equity in their homes if the value of the home is less than $50,000 and three percent equity if their home is more than $50,000. We believe this is reasonable. It recognizes the need for some equity in the property in order to ensure against default, yet it balances FHA's social role because two or three percent equity is less than the downpayment required if the loan were privately insured. If a loan is insured by one of MICA's members, the loan-to-value ratio must be 95 percent.

Adequate Premium. The Administration's proposal and S. 566 also recognize the need for FHA to better price to the risk it insures by requiring a small renewal premium to be paid if the borrower puts down less than 10 percent. The length of time the borrower pays the premium depends on the downpayment. This proposal balances FHA's social role with its need to be fiscally responsible because the premium is based on the risk of the loan, yet the 3.8 percent upfront premium can be financed.

As with the downpayment requirement, FHA still would be offering borrowers a significant subsidy feature that the private sector does not offer. Under the proposal adopted in S. 566, borrowers would be able to finance the 3.8 percent premium. Also, the loan-to-value ratio for FHA is calculated only on the appraised value of the property and any closing costs that are financed. Moreover, the loan-to-value ratio will not include the financed premium. With a privately insured loan, the upfront premium can be financed only if the total loan-to-value ratio, including the financed premium, is 95 percent.

Appropriate Loan Limits. Finally, Secretary Kemp recommended in his testimony before the Senate Banking Committee that FHA's loan limits not be raised. He stated that the Administration "does not believe that the Federal government should be providing mortgage insurance for high-income homebuyers. Its historic and proper mission is to serve low and moderate income homebuyers." Secretary Kemp concluded that "Federal credit should not be used to allow someone with an income of $75,000 to buy a house worth $185,000 with a five percent downpayment. That is a use of Federal resources which cannot be justified."

The Price Waterhouse actuarial study also said that "raising the loan limits appears to have little effect on the economic value or soundness of the fund. Most of the additional capital produced by raising the limits is required to protect against defaults of the larger loans." They observed that as the fund "insures higher income households, as represented by larger loans, the social purpose argument becomes less compelling, and, thus higher capital standards and insurance premiums become more appropriate."

MICA agrees with the conclusions of Secretary Kemp and Price Waterhouse and is pleased the Senate did not raise the limits above the current level of $124,875 in high cost areas. MICA also hopes that Congress and other housing policymakers will continue to examine targeting FHA by income. This is the only way to ensure that FHA helps average working Americans acquire their own home. Its goal should be to help low- and moderate-income people buy and keep homes, rather than enable more high-cost houses to be sold with more favorable financing terms.

Appendix II illustrates the housing affordability problem this country faces today. It shows that the rate of homeownership for families earning more than $50,000 has increased in recent years, while the rate of homeownership for people earning less than that has remained stagnant or decreased. A Federal program designed to increase homeownership should be directed to people who are having trouble purchasing a home, not to a group of people where homeownership is increasing.

Raising FHA's loan limits will not help families with less than $50,000 income purchase homes. In fact, only a family earning more than $50,000 can afford to purchase a home at the present FHA loan limit of $124,875 in high cost areas. The only way to direct more Federal homeownership assistance to families in the affordability gap is to target FHA by income.

MICA also believes that targeting FHA by income will not place any unnecessary financial risk on FHA. Data from the mortgage insurance industry shows that defaults increase with very high loan amounts. (See Appendix III). Therefore, raising the loan limits will not only direct FHA away from the people who need it, but potentially worsen FHA's financial situation.

Role of Private Insurers

The private mortgage insurance industry, like FHA facilitates homeownership in America. Since the industry was founded in 1957, it has helped nine million families buy homes with small down payments. The industry fulfills its mission by protecting lenders and investors against the added risk of default associated with low downpayment loans.

In recent years the industry has been working with local consumer groups in a number of U.S. cities to identify how we can better serve low- and moderate-income home buyers. This partnership has effectively increased the industry's awareness of the unique needs of low- and moderate-income home buyers at a local level, and helped motivate revisions to underwriting guidelines of individual members of the industry. These revisions increase the flexibility of underwriting policies for appropriate low- and moderate-income families, and they also enhance the industry and its customer awareness of the special needs of lower income home buyers.

The industry's relationship with community groups has translated awareness into involvement through the development of demonstration programs designed to explore ways to increase homeownership opportunities for low- and moderate-income families. These demonstration programs coordinate the resources of local community groups, mortgage lenders, mortgage insurers and the secondary market agencies in public-private partnerships to help meet communities' housing needs. Homeownership opportunities are developed by combining financial counseling for prospective borrowers with more liberal mortgage underwriting criteria.

These programs are termed "demonstrations" because they are designed to demonstrate that by working together, communities, lenders, insurers and investors can expand homeownership

opportunities for low-and moderate-income families. As these programs evolve and their success is evaluated and monitored, they will ideally point the way toward increasing homeownership opportunities for all home buyers across the nation. It is clear to us that in the decade of the 90's, all participants in the mortgage finance system are going to have to work hard to serve all segments of their community. Our industry wants to lead the innovation.

The mortgage insurance industry also wants to insure that FHA is there in the future to serve low- and moderate-income people. This is why we support the provision in S. 566 to restructure FHA. Without these key changes to the program we are afraid FHA will not be available to serve the next generation of homebuyers.

SENATE COMMITTEE
ON
BANKING, HOUSING AND URBAN AFFAIRS

SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

Testimony of
Dwight Robinson, Deputy Director
Michigan State Housing Development Authority

on Behalf of
the
National Council of State Housing Agencies

July 24, 1990

Testimony of Dwight Robinson, Deputy Director,
Michigan State Housing Development Authority
on Behalf of the
National Council of State Housing Agencies
Before the
Senate Committee on Banking, Housing and Urban Affairs
Subcommittee on Housing and Urban Affairs
on the Federal Housing Administration's
Mutual Mortgage Insurance Fund

July 24, 1990

Mr. Chairman, Mr. D'Amato and Members of the Subcommittee, my name is Dwight Robinson and I am Deputy Director of the Michigan State Housing Development Authority (MSHDA). I am here this morning on behalf of the National Council of State Housing Agencies (NCSHA) which represents the housing finance agencies (HFAs) of the fifty states.

NCSHA welcomes this opportunity to comment on the future of the Federal Housing Administration's (FHA's) single-family Mutual Mortgage Insurance Fund ("the Fund"). Since more than 60 percent of the nearly 95,000 Mortgage Revenue Bond (MRB) mortgages written for first-time, low and moderate income homebuyers in 1989 were FHA insured (up from only ten percent in 1985), State HFAs have a strong stake in the continued health and availability of this insurance program on behalf of America's working families.

I would like to make three key points in my testimony this morning:

- State HFAs are relying more and more on FHA insurance in combination with below market interest rate MRB loans to reach low and moderate income (50 to 100 percent of area median income) first-time homebuyers.

- FHA "reforms" advanced by the Administration and adopted by the Senate would disproportionately burden low and moderate income homebuyers, denying many homeownership opportunities.

- Measures can be taken to ensure the FHA's financial health without endangering FHA's social mission -- making the dream of homeownership attainable by low and moderate income people -- a goal Secretary Kemp shares.

NCSHA is a national, not-for-profit organization created in 1970 to represent the interests of State HFAs in low and moderate income housing. HFAs in every state, the District of Columbia, Puerto Rico, and the Virgin Islands respond to low and moderate income housing needs through the

financing, development, and preservation of affordable ownership and rental housing. HFAs collectively operate more than 350 affordable housing programs, which range from homeownership to homeless initiatives.

State HFAs have helped more than 1,000,000 low and moderate income Americans buy their first home through MRB programs which they administer in every state. These HFAs issued approximately $6 billion in MRBs in 1989 under the private activity bond cap which strictly limits the overall volume of such bonds. In 19 states, these HFAs also operate Mortgage Credit Certificate (MCC) programs.

NCSHA's member HFAs have also financed over 500,000 units of rental housing for low and moderate income tenants through reduced interest rate mortgages financed by tax-exempt bonds. Since 1986, NCSHA members have financed 235,000 low income rental units with the Low-Income Housing Tax Credit for households with incomes at 60 percent or less of area median.

The MRB program is the only generally available federal mortgage assistance program in today's disheartening environment of climbing home prices and declining homeownership rates. Yet, it is scheduled to expire at the end of this year. An overwhelming 85 percent majority of the Congress -- 457 of the 535 House and Senate members, including 70 percent of the members of both tax-writing committees -- have co-sponsored legislation in this Congress to extend this time-honored, well-tested, and Congressionally limited program to make the national goal of homeownership attainable by lower income Americans. We urge you to support a permanent MRB extension in this year's Budget Reconciliation bill.

The imminent MRB sunset date is not the only threat to the MRB program and homeownership opportunities generally for low and moderate income people. Provisions advanced by the Administration and adopted by the Senate to the National Affordable Housing Act (S. 566) to ensure the financial solvency of the FHA Fund threaten to deny homeownership to many potential MRB borrowers and other first-time homebuyers. The impact of those changes would fall disproportionately on first-time homebuyers of low and moderate income who lack the cash equity to incur additional "up-front" charges and who can least afford the additional monthly surcharge imposed on low downpayment loans.

NCSHA wholeheartedly supports Congressional action to restore the FHA Fund to actuarial soundness. A strong and vital FHA must be at the heart of any comprehensive national housing policy. However, the cost of maintaining the Fund's solvency should not be borne by the most needy and captive of FHA's borrowers. In its effort to promote sound FHA business practices, the Congress must not lose sight of FHA's historical purpose -- providing affordable mortgage credit to deserving low and moderate income homebuyers across America.

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Aid to First-Time Homebuyers Has Never Been More Important

Since the early 1970's, there has been a dramatic increase in average home price relative to average income. According to current data compiled by Harvard University's Joint Center for Housing Studies, in 1989, the average after-tax cost of homeownership for first-time homebuyers was 33.1 percent of income, over 50 percent higher than in the early 1970's. The cost of a downpayment equalled 55.9 percent of income, 25 percent more than two decades ago. These high costs have put homeownership out of the reach of an increasing number of low and moderate income people.

According to the Harvard statistics, the national rate of homeownership in 1989 was 64 percent, down from 65.6 percent in 1980. The study found that the decline from 1980 to 1989 was greatest among younger households, with the homeownership rate for 25-29 year-olds dropping from 43.3 percent to 35.4 percent, for 30-34 year-olds from 61.1 percent to 53.6 percent, and for 35-39 year-olds from 70.8 percent to 63.9 percent. Despite the disparity in house price inflation across geographic regions, homeownership rates are down throughout the country.

HFAs and the FHA Have Worked Together to Reach Lower Income Buyers

The importance of FHA insurance to State HFAs, and more directly to low and moderate income first-time homebuyers, cannot be overstated. From 1986 to 1989, 40 HFAs reported to NCSHA the composition of mortgage insurance backing their loans in each of those years. In 1986, only ten agencies looked to FHA for the majority (60 percent or more of their loans) of their coverage. By 1987, this number had doubled with twenty agencies relying on FHA to insure the majority of their loans. By 1988, this number increased to 28 agencies relying primarily on FHA, and by 1989 it had risen to 33 agencies.

Even more instructive is the percentage of each of those 33 agencies' loans which were FHA insured in 1989: five agencies made 100 percent FHA loans, eight made from 90 to 99 percent FHA, and another nine made from 80 to 89 percent FHA. Clearly, FHA has become more important than ever in helping first-time homebuyers enter the market.

State HFA MRB programs are extremely diverse. In some states, the HFAs' enabling legislation requires that loans must be insured through FHA or VA. The historical experience of some HFAs, therefore, is based entirely on FHA underwriting. In other states, private insurers may be providing coverage, at affordable rates and with reasonable terms, which is sufficient to meet the needs of first-time homebuyers. HFAs in these states may experience limited demand for FHA insurance. However, during the past five years, HFAs overall have moved from predominantly private insurance to predominantly FHA coverage for the first-time homebuyers they serve.

Michigan is one of over twenty states with more than 75 percent FHA insured loans in our latest loan pools. In the last 15 months, MSHDA has worked with funds from two bond issues totaling $189 million. To date, we have committed $135.2 million for 3,367 loans. A total of 3,121 existing homes and 246 new homes were financed. FHA insurance assisted the purchase of 2,660 loans totaling $106.1 million, or 79 percent of the total, the remainder being supplemented by VA or private mortgage insurance.

Ninety-two percent of these families were buying their first home, with an average purchase price of $38,803. The average income of these buyers is $24,548, which is just under 65 percent of the state median income of $37,800. Without FHA insurance, many of these families would have been unable to make the transition from renting to homeownership.

The shift from private mortgage insurance to FHA insurance is clearly illustrated by the Rhode Island Housing and Mortgage Finance Corporation's (RIHMFC) experience. Prior to 1988, very few residential loans in Rhode Island were insured by FHA. By 1988, however, RIHMFC began turning increasingly to FHA because private insurers were lowering their debt to income ratios, rejecting the use of gift letters, and increasing downpayment requirements, thus limiting their usefulness to the first-time homebuyer. In contrast, FHA's underwriting was much more flexible, allowing the use of higher debt ratios, residual underwriting, and lower downpayment guidelines.

FHA underwriting and other reforms instituted in 1989 have already had a profound effect on the program. Price Waterhouse's report regrettably looks at an earlier and very different FHA. I am disturbed that Congress is considering further program tightening without understanding the full impact of these very recent and significant changes on FHA's lower income borrowers.

Countless other HFAs share our excitement about the role FHA had begun to play in their states, as well as our concern about the recent and proposed changes. The Virginia Housing Development Authority's (VHDA) portfolio currently consists of approximately one-third FHA-insured loans. From 1974 to 1986, in fact, VHDA relied solely on private insurers. In 1986, VHDA began experiencing problems with the private insurers. VHDA began accepting FHA and VA guaranteed loans in 1986, and since that time, approximately 90 percent of their homeownership production has been FHA/VA. VHDA has maintained their usual careful underwriting practices, and has experienced no significant changes in delinquency or foreclosure rates. This is particularly impressive since they are serving families at only about 70 percent of the state's median income level. If anything, VHDA is more stringent than the Direct Endorsement lenders FHA currently uses, often rejecting loans for purchase which are acceptable under FHA standards.

Minnesota, South Dakota, and Ohio have had similar experiences. In Minnesota, the Housing Finance Agency's (MHFA) portfolio includes about 25 percent FHA-insured loans. However, for the past two years, 80 percent of all the loans MHFA has made have been FHA-insured. The increase is due to changes in the terms offered by private insurers, and a concerted training effort undertaken by both FHA and the MHFA staff. Once lenders were trained on the processing of FHA loans, they found it to be a better alternative for most MRB-assisted first-time homebuyers.

Similarly, in South Dakota the Housing Development Authority (SDHDA) has a portfolio which includes 67 percent FHA-insured mortgages. The current bond series, however, includes nearly 80 percent FHA-insured mortgages. In Ohio, since 1988 100 percent of the MRB loans made have been FHA-insured.

The experience of the Connecticut HFA indicates that not only do MRB programs depend on FHA insurance for their success, but at times FHA may not be successful without MRB financing. In Connecticut, for several years in the mid-1980's, the Housing Finance Authority's (CHFA) home mortgage program represented a significant share of all FHA business in the state--at some points as many as eight out of every ten FHA-insured single family mortgages originated. Many of these borrowers would not have entered the market at all without the lower-interest rate MRB loan and the downpayment assistance offered by the state's Department of Housing. The third piece, FHA insurance, was obviously essential to their ability to enter the market. These FHA borrowers in Connecticut tend to be working class households, with two wage earners, and are disproportionately urban and minority.

Limited Alternatives Exist to FHA and Traditional Private Insurance

Although limited, the states have some experience with alternatives to both FHA and "traditional" private mortgage insurance coverage. Because the tightening of both these resources has reduced their capacity to serve first-time homebuyers, states with the resources to do so have looked at two primary alternatives: the development of risk-sharing agreements with private insurers and the development of agency or self-insurance funds.

The risk-sharing approach allows HFAs to work with private insurers to develop special agreements based on the specific experience of and resources available to the agencies. These risk-sharing agreements may lead to below market pricing of mortgage insurance premiums, more flexible underwriting criteria, and subsequently lower capital outlays for both the agency and the borrower.

Since they require the agency to take on more financial risk, these programs are only an option for those few HFAs which are able to contribute funds for a collateral account and take on a general obligation pledge for uncollateralized portions of the risk. Rhode Island, New Hampshire,

Pennsylvania, and Massachusetts have implemented risk-sharing agreements with private insurers.

A second approach has been to develop state or agency-sponsored mortgage insurance funds. This has been done in California, Connecticut, Massachusetts, Pennsylvania, Rhode Island, Vermont and Maryland. These funds serve only that portion of borrowers who cannot be served through FHA, VA or private insurers, in a cost-effective manner, or, in some cases, at any cost.

Self-insurance funds can have the same benefits as risk-sharing agreements, but in general, require a much more substantial financial commitment from the agency, placing them out of the reach of most HFAs. The agency must provide funds for initial capitalization of the fund, and may require that a large fund balance be maintained as back-up capital. The development of such funds is a very complex and staff-intensive process. In short, neither risk-sharing agreements nor self-insurance funds will ever serve as replacements for an adequate supply of FHA and "traditional" private mortgage insurance.

The Cumulative Effect of Recent and Proposed FHA Reforms

NCSHA supports proposed administrative and management changes which will protect the financial solvency of the FHA Fund. Without a stable Fund, future lending activity will be jeopardized, and even more radical changes may be proposed. At the same time, we believe that several of the changes the Congress is currently considering, on top of recent FHA underwriting and other reforms, will have the cumulative effect of excluding many first-time homebuyers from the ownership market altogether.

We have reviewed the Price Waterhouse study of the FHA program which prompted these proposals and believe that its focus is too narrow. The report addresses risk nearly exclusively from a downpayment/equity/loan-to-value perspective, while virtually ignoring other important risk factors such as operational and administrative deficiencies.

FHA's 1989 revised underwriting procedures give lenders far less flexibility to consider extenuating factors like credit history problems or high debt-to-income ratios. These changes have already begun eliminating many "marginal" borrowers from the program.

Additionally, monitoring of direct endorsement lenders, which is essential to ensure properly underwritten and documented loans, was strengthened by FHA in 1989. Prosecutions for fraud and administrative sanctions for bad business practices are now more common. Stepped-up review of direct endorsers should be bolstered even further.

Other recent program changes which are likely to have a profound effect on the quality of FHA's loans are the banning of investor loans and the requirement that credit reviews be performed on purchasers in all assumption transactions.

While we consider some of these changes severe, we believe that FHA will realize reductions in losses and improvements in loan pool quality as a result of the cumulative 1989 reforms and that these improvements will be sufficient to warrant postponement of further drastic changes. Although you will receive much more detailed information from the Mortgage Bankers Association (MBA) on delinquency and foreclosure trends, it bears repeating that the latest MBA reports show claims for the first half of fiscal year 1990 down five percent from the comparable period in 1989.

Impact of Senate Provisions on Lower Income First-Time Borrowers

The burden of the Senate-adopted increase in closing costs and insurance premiums would fall disproportionately on lower income homebuyers and in some cases would deny them homeownership. Higher incomes would be necessary to support the higher "up-front" and monthly costs. Since MRBs serve low and moderate income first-time homebuyers exclusively, our borrowers would be severely affected.

Existing provisions of the tax code limit MRB assistance to lower income purchasers whose incomes may not exceed 115 percent (100 percent for families of fewer than three persons) of the higher of the area or statewide median gross income. In practice, HFAs frequently set their purchaser income limits well below the federal limits. Last year, conventional first-time borrowers' incomes averaged 44 percent above MRB borrowers' average incomes. Some HFAs target as low as fifty percent of area median income, and many target between 80 and 100 percent.

Closing Cost Requirements

The Senate proposal requiring that two-thirds of closing costs be paid up-front would present in some cases an insurmountable obstacle to the MRB-assisted, first-time homebuyer. Even under current FHA rules, our borrowers often need help meeting their up-front cash requirements. For this reason, more than 20 states now offer downpayment or closing cost assistance.

Our borrowers often would simply lack the estimated $1000 to $1500 additional cash equity which would be required under the Senate proposal. Those who might be able to come up with the necessary cash would likely exhaust all savings, creating further financial stress on these households and increasing the likelihood of delinquency and default.

It is unrealistic to expect, as Price Waterhouse suggests, that borrowers need only "wait longer" to save up the downpayment required

under current proposals. Federal Reserve Board statistics indicate that the average, not to mention low to moderate income, household in America saves six percent of income per year. Assuming a $100,000 purchase price, a borrower would have to save $375 a month to amass the required $4,500 downpayment in one year. If this were the average American borrower/saver, he would have to earn $75,000 per year. During the extra year when this borrower was saving $4,500 of his $75,000 income, the $100,000 house will have appreciated by five to six percent, so that he now needs $4,800 and still cannot buy the house.

National data indicates that up-front entry costs represent one of the biggest barriers for first-time homebuyers entering the market. It would be nearly impossible for low and moderate income borrowers to save a sufficient amount from limited incomes stretched by ever increasing rent burdens and other costs. Lower income borrowers need the extra boost which FHA was created to provide.

We are also very concerned that the Senate requirement that no mortgage exceed 98 percent of appraised property value would limit the ability of HFAs to provide borrowers downpayment assistance. In the past, FHA has allowed such assistance, but the Senate language seems to imply that two percent of the appraised value must be provided "out of pocket" and may not be covered by the downpayment assistance.

Risk Based Premiums

The Senate-proposed additional .5 percent monthly premium for "high-risk" borrowers unfairly penalizes those borrowers who are least able to afford a higher monthly payment. While the dollar impact may be small -- an estimated five to twenty dollars a month -- every dollar counts to the lower income first-time homebuyer.

If an additional premium must be imposed, it should be imposed across-the-board on all FHA borrowers and not just on those who make downpayments of ten percent or less. Everyone who benefits from the Fund should contribute equally to its financial health.

Delinquency and foreclosure rates in State HFA portfolio's are exceedingly low and in no way support the view that the source of the FHA Fund's problem is the low-income, high loan-to-value (LTV) ratio borrower. MBA statistics which show that every category of LTV below 80 percent lost money for FHA from 1981 to 1985 are also at odds with this conclusion.

Conclusion

We share the Congress' concern about the financial health of the FHA Fund and believe that all necessary steps should be taken to assure its viability. We believe, however, that recent reforms, once allowed to work, will go a long way toward securing the Fund. Should further reforms prove

necessary, there are sound options at your disposable which would not penalize lower income borrowers. These include the suspension or termination of distributive shares and the elimination of premium refunds. The FHA's priority should be putting people in homes, not further rewarding those who have already reaped the Fund's benefits. Representatives Vento's (D-MN) and Ridge's (R-PA) proposed House floor amendment works in this direction and we support it.

There comes a point at which one must stand up and say, as Alice did to the Queen of Hearts, "Nonsense!" We need "actuarial soundness" and "sound accounting practices." But we need these things to help us accomplish the ends we seek, not as ends themselves.

American families dreaming the American dream need a healthy, vital FHA -- just as our parents needed it over the past fifty years. FHA should be at the core of a National Housing Policy. We should look for opportunities to innovate. There is no reason that State HFAs could not negotiate risk-sharing agreements with FHA. Instead of finding ways to keep out working families, the pending national affordable housing legislation should fund a pilot no downpayment program that utilizes the expertise of FHA. The Price Waterhouse Study should be an input -- and an important one -- into a full-scale programmatic audit of the role of FHA in today's environment. This audit should involve not only accountants, but consumers, lenders, nonprofits and representatives of state and local government.

As Cheshire-Puss said, "Which way we go from here depends a good deal on where we want to get to."

Thank you for the opportunity to testify before you this morning.

Testimony of

John M. O'Brien
President and Chief Executive Officer
Central Pennsylvania Savings Association

on behalf of

The National Council of Savings Institutions

Before the
Subcommittee on Housing and Urban Affairs

of the

Committee on Banking, Housing and Urban Affairs
United States Senate

July 24, 1990

Statement of
John M. O'Brien
President and Chief Executive Officer
Central Pennsylvania Savings Association
on behalf of
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Subcommittee on Housing and Urban Affairs
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Committee on Banking, Housing and Urban Affairs
United States Senate
July 24, 1990

Mr. Chairman, my name is John M. O'Brien. I am President and Chief Executive Officer of the Central Pennsylvania Savings Association, a stock savings and loan in Shamokin, Pennsylvania, with $475 million in assets. I am appearing today in my capacity as the Chairman of the Government Affairs Committee of the National Council of Savings Institutions. I appreciate the opportunity to appear today to present the views of the National Council of Savings Institutions on the Federal Housing Administration's (FHA) single-family mortgage insurance program administered under the Mutual Mortgage Insurance Fund (MMIF).

The National Council shares the concern of this Subcommittee about the FHA insurance fund. The FHA has been in the business of insuring very high loan-to-value (LTV) ratio mortgages. FHA mortgages may in fact be larger than the value of the home used as collateral for the loan. This high LTV lending poses significant risk to the insurance fund. A similar government lending program, the Veteran's Administration guaranteed lending program, has been involved with high LTV loans and has also incurred substantial losses.

The FHA's high LTV lending lies both at the heart of the FHA's problem and the reason for its existence. While presenting risks that any private mortgage insurer would avoid, the FHA's low downpayment provides first-time homebuyers and others access to homeownership.

Given the nature of the lending supported by the FHA's single-family insurance program, and the general decline or leveling off of real estate price appreciation in selected markets across the nation, it is not surprising that the FHA program is facing financial problems. We support the efforts of this Subcommittee in addressing these problems and working to get the FHA single-family part of the MMIF back on an actuarially sound footing. This effort is critical in assuring that the FHA is available for the long term to support the homebuying needs of low- and moderate-income homebuyers who otherwise would not be able to purchase a home of their own.

Long-term Housing Outlook:

There has been much documentation of the recent weakening in home prices and the future outlook for inflation in housing values. The Administration's FY 91 budget message notes that the federal government stands behind much real estate lending through deposit insurance, loan insurance and guarantee programs, and federally sponsored secondary market agencies.

The FY 91 budget message points out that "federal housing credit programs worked well in the environment of rising house prices and low interest rates that characterized much of the post-World War II period. Since 1980, market conditions have not been as favorable to guarantors of mortgage credit. This trend will probably continue." In addition, the budget states that "fewer people will be entering their home buying years in the next two decades. Reduced demand may slow the increase in housing prices. Mortgage default rates tend to rise when appreciation slows, increasing federal mortgage insurance losses."

Housing Appreciation Reduces Risk:

During the highly inflationary 70s and early 80s, the escalating values of real estate covered up many of the problems of poor underwriting. If borrowers could not meet monthly payments, properties could be sold profitably and loans paid off without the need of going through foreclosure. Borrowers would struggle to pay mortgages representing a higher percentage of monthly income, because the investment return on the property was so great.

In deflationary times, however, if a borrower could not meet payments, the ability to sell the property and recover losses evaporated. Exacerbating lenders' problems were borrowers who could make payments but exercised their option to walk away from a property. This often happened when a homeowner saw a neighbor's house selling for less than the outstanding principal balance on his own house, so the sacrifice of making monthly payments appeared to be too great.

In fact, the vast majority of real estate losses today stem from this reduction in the inflation that drove real estate prices up consistently through the late 70s and early 80s. Deflationary trends appeared in many parts of the country and were most significant in regions with dominant industries suffering severe problems, such as the oil belt and agricultural regions.

Higher LTV Equals Higher Risk:

Loan-to-value has been a particularly sensitive measure of relative risk, since it delineates the degree to which the borrower has a stake in the property, especially in the early years of the loan. In 1985, Moody's Investors Services did an extensive analysis of the private mortgage insurance industry. The study looked at the nature of risk from a lender's or insurer's point of view. A copy of that study is attached as Exhibit #1.

In order to examine the relative risk of loans by original loan-to-value ratios and to compare the experience of firms over time and under various economic situations, Moody's requested and received claims/survivorship data by loan type, loan-to-value, and year of origination for seven firms in the industry. These seven firms represented 90% of private mortgage insurance in force at that time.

Based on claim rates for combined data sets, the study reflected the general experience of the MI industry on more than 4 million loans classified by loan-to-value. Based on data on all loans originated by these seven firms from 1957 to 1983, loans with 5% to 9% down (91%-95% LTV) were 1.69 times as risky as loans with 10% to 14% down (86%-90% LTV), and 3.25 times as risky as loans with 15% to 19% down (81%-85% LTV).

Obviously, loans with 100 percent or more LTV are even more risky. This is supported by the Price Waterhouse study.

Need for a Viable FHA Program:

The disturbing trend of declining homeownership over the past decade in the 25-35 year old age group certainly demonstrates that there is still a pressing need for a government loan program to assist first-time homebuyers. Any effort in the Congress to address the FHA's financial weakness must balance budget needs to prevent the need for a federal bailout of the FHA fund, while maintaining the FHA fund for future homebuyers that otherwise would not be able to purchase a home.

The primary attraction of FHA loans to first-time homebuyers is the limited downpayments needed. Other than the cost of the house itself, the two major problems confronting first-time homebuyers in getting mortgage financing are accumulating the downpayment and qualifying for the loan. While interest rates have remained relatively low and the ability of borrowers to carry a monthly payment has been strong, the first-time buyer has met significant problems in accumulating funds to cover closing costs and the downpayment, which, in the case of a second-time buyer, often comes from the proceeds of the sale of the first house.

Now I would like to address some of the specific provisions in the various FHA proposals being considered at today's hearing. Both the provisions passed by the Senate in S 566, The National Affordable Housing Act, and those proposed by Representatives Vento and Ridge, would enable the FHA borrower to put less money down than a borrower taking out a conventional loan with private mortgage insurance.

The Senate provision limits the full funding of all closing costs, and this provision will help keep LTV ratios lower than they otherwise would be. The Senate also charges a risk-based premium for the highest LTV loans. Both these provisions, if adopted, will dramatically improve the financial condition of the FHA fund, but will also make the FHA program unavailable to the most marginal borrower.

However, the Senate bill retains the existing up-front funding of premiums that was adopted in 1983. When the insurance premium was raised to a 3.8 percent up-front premium that could be financed as part of the loan, LTV ratios were increased even more. It is ironic to note while this approach to load the premiums up-front helped the federal budget situation, it increased the ultimate risk of the FHA fund.

The Vento approach reduces the up-front premium load while employing the previous FHA practice of annual premiums of 50 basis points. This approach reduces the LTV by limiting the payment of the full premium at origination. The Vento-Ridge proposal also eschews the risk-based premium so that arguably those borrowers posing the least risk to the FHA fund, those with larger downpayments, will be subsidizing those borrowers presenting a higher risk.

There are positive elements in both the Senate provision and the Ridge-Vento proposals. The National Council supports the effort represented by both approaches to reform the FHA insurance fund and keep it a viable ongoing element in the nation's housing finance system.

Mr. Chairman, thank you for the opportunity to appear at today's hearing.

Exhibit #1

Focus On **STRUCTURED TRANSACTIONS**

Industry Outlook: Private Mortgage Insurance

Private Mortgage Insurance: An Industry in Transition

March 1985
Moody's Investors Service

Appendix 2 - Risk Analysis

Detailed analysis of risk exposure is a key element in Moody's assessment of the mortgage insurance industry and one which we have found especially useful in measuring relative strengths and weaknesses of the major firms in the industry. A mortgage insurance company's risk exposure reflects the combination of many different elements, all of which relate directly to the net equity position of loans within a portfolio and/or the ability to meet scheduled changes in monthly payments. The m[illegible] risk elements include the following:

- The geographic dispersion of business,
- The loan-to-value mix,
- The type of loan instrument and loan c[illegible]teristics, and
- The relative price appreciation on the underlying collateral for the loans insured, usually associated with the relative age of the loan portfolio.

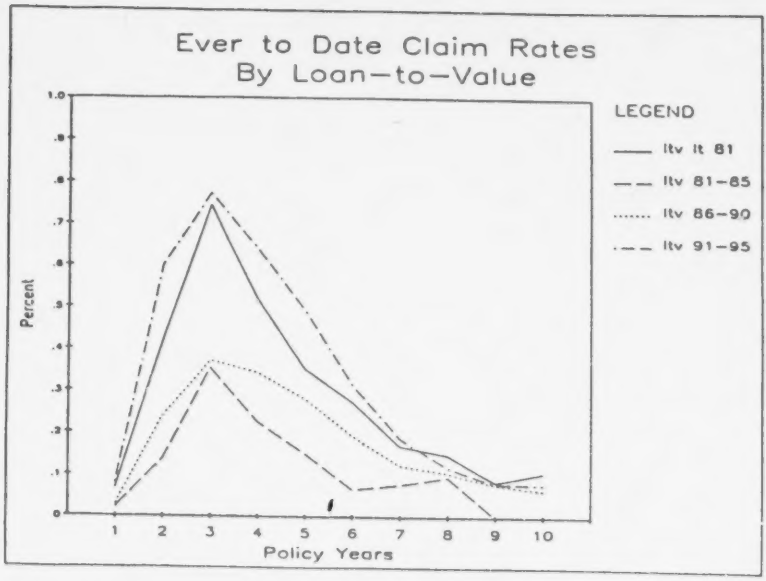
Location of a property is a particularly important element. Local economic conditions affect the probability of default of an individual loan more than the national economy does. Consequently, the greater the geographic distribution of a firm's risk exposure, the less risk there is that purely local economic dislocations wil[illegible]tly affect the company's performance.

Perfect geographic distribution (with all other things being equal) would imply a distribution in proportion to the observed distribution of all private residences. However, localities are not equal in their vulnerability to economic dislocation. Default statistics by state indicate that certain states have had consistently higher default rates and others have had consistently lower ones. (See Table 3.) A firm's performance could therefore be improved if it concentrated in areas of lower default. To a great extent, the industry has followed this pattern, since lower default rates are often associated with economic expansion and growing land values and house prices. However, boom markets sometimes fall upon hard times, like the Houston housing market. Thus the traditional method of managing risk, of spreading out risk exposure as best one can, remains the optimal long-run strategy.

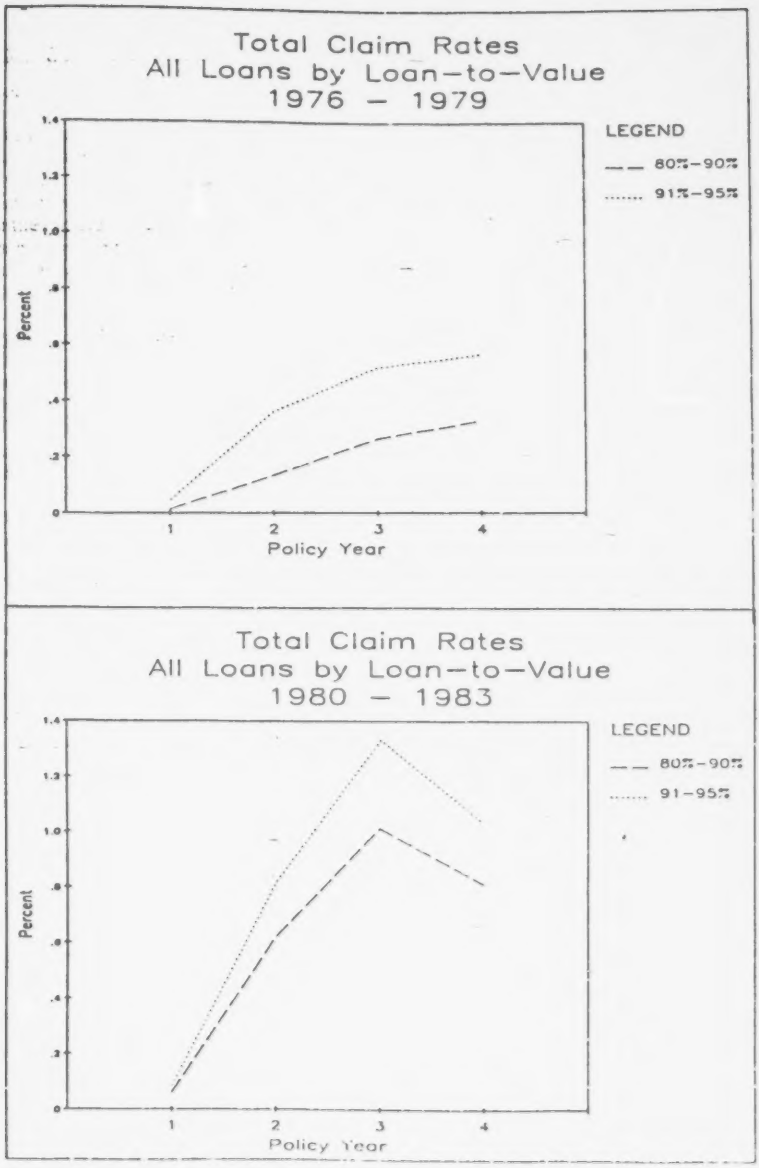
Table 4 displays the geographic distributions of those firms currently rated by Moody's and compares them with the industry average. The larger and older firms in the industry generally have better geographic distributions and lower state concentrations.

Loan-to-value has been a particularly sensitive measure of relative risk, since it delineates the degree to which the borrower has a stake in the property, especially in the early years of the loan. The higher the down payment, the less is the likelihood that the borrower will walk away from the loan. In order to examine the r[illegible]isk of loans by original loan-to-value and to cor[illegible]perience of firms over time and under various economic situations, Moody's requested and received claims/survivorship data by loan type, loan-to-value, and year of origination from seven firms in the industry. These seven firms currently account for 90% of private mortgage insurance in force.

Based on ever-to-date claim rates for combined data sets, the graphs opposite reflect the general experience of the MI industry on more than 4 million loans classified by loan-to-



The graph shows the claim rates by policy year of all companies included in the peer group. The data are based on the default experience of over four million privately insured loans originated between 1957 and 1983.



These two graphs show claim rates over two seperate time periods. The higher claim rates experienced during the 1980-1983 period can be attributed to the combined effects of high unemployment and low price appreciation.

value. Based on data on all loans originated by these seven firms from 1957 to 1983, loans with 5% to 9% down (91%-95% LTV) were 1.69 times as risky as loans with 10% to 14% down (86%-90% LTV), and 3.25 times as risky as loans with 15% to 19% down (81%-85% LTV). Loans with more than 20% down usually do not require private insurance. Those that do, however, usually entail some additional risks--chief among them are status as a vacation home, a non-owner-occupied property, or location in a declining or marginal area. As a result, privately insured loans with less than 80% LTV have exhibited default rates which exceed even those loans with only 5% down.

Seasoning is an element which is generally associated with growth in net equity position. While loan balances are paid down over time, early principal payments are quite small for several years. Consequently, most of the growth in net equity is due to market value appreciation. Net equity position, over time, has been established as the key determinant of default probability by several studies of FHA data and has been confirmed for conventional loans by other researchers using loan data from MGIC. We have reaffirmed these conclusions using our own model of default probability, based on an even larger data base assembled from the seven MIs.

Moody's examination of claim termination rates over various periods of time indicates that inflation-induced equity positions of the 1970s were clearly responsible for keeping MI claim termination rates so low. Also from analysis of MI claim data, low future home price appreciation implies that relatively unseasoned loans, as well as all new loans insured, will incur higher default rates in the future than has been the industry's experience to date.

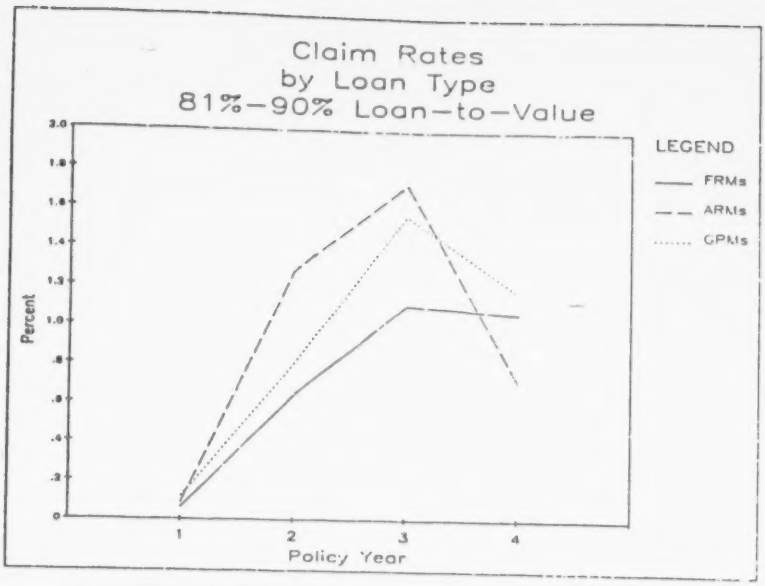
The same model and analysis were also used in estimating probable default rates and claim losses under various economic scenarios. Rather than defining a depression scenario by an assumed default rate on all loans, Moody's method assumes a slide in home values over time, coupled with rising unemployment and falling interest rates, to determine default rates based on the current makeup of the risk exposure of a particular firm. Those firms with less risk exposure (especially in terms of greater seasoning) would suffer lower default rates and losses than a firm with a higher degree of risk exposure.

The development of new types of loan instruments has introduced new elements of risk, some aspects of which are speculative in nature and cannot be actuarially defined. These instruments were originally designed to address the issue of housing affordability; by 1979, high interest rates and continued home price inflation had made home ownership difficult for many first-time homeowners. Adjustable-rate mortgages were later introduced, not only to reduce early-year interest costs but also to provide intermediaries with a reduction in interest rate risk.

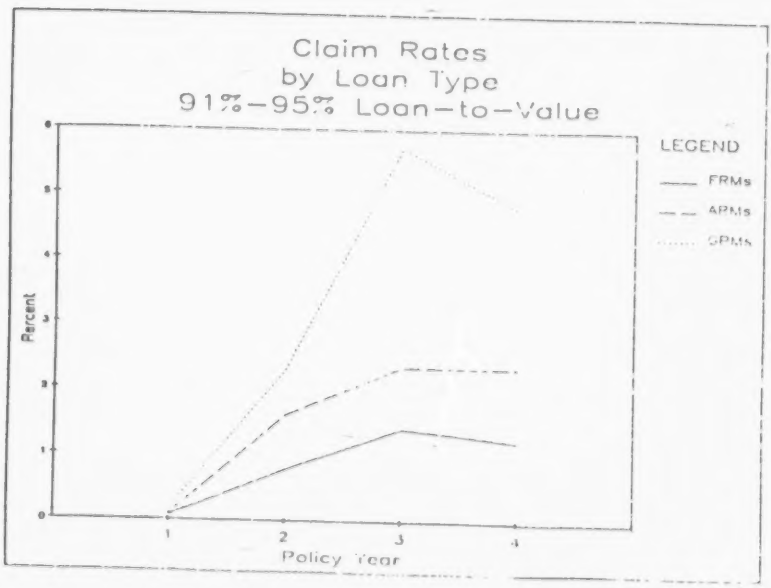
Differences in loan types affect both the borrower's equity position and his ability to make payments. Payments on normal, fixed-rate conventional loans are level, with speed of principal repayment determined by the coupon rate and the term to maturity. As long as a homeowner maintains employment and incurs no additional debt, his ability to meet monthly payments will not likely be affected. Many of the new loan instruments involve scheduled or potential changes in monthly payments. Such loan instruments assume that a borrower's income will increase over time at some minimum growth rate to meet the planned or unplanned adjustments to monthly payments.

Examples of the various loan types and their effect on payments and equity vary considerably. Most graduated payment mortgages (GPMs) have fixed interest rates but scheduled payment increases, as well as planned limited negative amortization in the early years of the mortgage. Growing equity mortgages (GEMs) have no negative amortization but do have scheduled payment increases, which rapidly increase the borrower's equity position. Builder buydowns were introduced to reduce interest costs in the early years of loans. Depending upon the size of the buydown, monthly payments increase to full regular payments within one to three years.

ARMs potentially can include all of the above characteristics, depending on what loan features have been adopted for a particular loan. The variety of features in ARMs makes this particular instrument difficult to assess and to track over time. However, there has been a marked trend toward greater standardization in ARM instruments, which will improve our ability to assess the risk exposure presented to mortgage insurers.



Rates are based on 1980-1983 data. Note the decline in fourth year ARM claim rates. ARMs of this age were mainly three-and five-year ARMs whose payments were adjusted downward in 1983 due to lower interest rates.



Rates are based on 1980-1983 data. The lack of a drop in fourth year ARMs claim rates is primarily due to the smaller initial equity position in such loans and the lack of any significant home price appreciation.

The graphics on the opposite page highlight the information gathered by Moody's on three of the major loan types insured by our sample of seven MIs. The data are compared for the years 1980-83 only. While some GPMs and types of ARMs were insured before 1980, their numbers were too small to be meaningful. Claim rates on fixed-rate standard mortgages referred to in the graphics were taken from the same 1980-83 period, so that the same economic forces and events affecting GPMs and ARMs would be accounted for. Claim rates on standard fixed-rate loans before 1980 conform most closely with the claim rates discussed in the section on loan-to-value.

Based on a sample of 578,490 fixed-rate standard mortgages (FRMs), 53,555 GPMs, and 219,691 ARMs, GPM loans with 81%-90% LTV were 28% more likely to default than fixed-rate standard conventional loans, while ARMs were 32.2% more likely to default. We attribute the surprisingly low difference in observed claim termination rates to the fact that the bulk of the seasoned ARMs in this period were three- and five-year ARMs, whose first adjustments were made at a time of declining interest rates. Most of the one-year ARMs currently outstanding were originated in 1983 and 1984. Therefore, the effects of sharp upward payment adjustments are largely not present in the 1980-83 data. Despite these caveats, ARMs with 95% LTV were 84.6% more likely to default than FRMs. GPMs in the 91%-95% LTV range defaulted at a rate 3.73 times that of FRMs.

At this point, until more clearly defined ARM data are available, it would apear that GPMs may be our best proxy for potential ARM credit risk. Nearly all of the GPMs in the sample carry scheduled payment increases of 7.5% for the first five years, as well as some built-in negative amortization. Since 7.5% payment increases correspond roughly to a 1% interest rate cap, one might further speculate that loans allowing a 2% annual cap might carry potential claim frequencies that would be more than twice the credit risk of 1% caps. Data from 1984 and the next several years will be required before we can obtain a fuller understanding of the true potential risk of these instruments.

Moody's has reached the following conclusions, based on this vast array of information and our modeling simulations:

1) Given the large degree of difference in past claim termination rates between 91%-95% LTV loans and 81%-90% LTV loans and the relatively small difference in their pricing, cash flow analysis suggests that until the most recent adjustments in premium rates, 91%-95% LTV loans were underpriced relative to potential claim losses.

2) Unseasoned and higher LTV loans will likely suffer higher claim rates in the future, due to expected lower home price appreciation in the future.

3) Certain risk elements, when combined with other riskier characteristics, appear to have an exponential effect on default rates, as demonstrated by the GPM and ARM data.

4) Also based on GPM and ARM observations, such loans originated before recent premium changes were seriously underpriced relative to their inherent risks.

STATEMENT

of

THE NATIONAL ASSOCIATION OF HOME BUILDERS

Submitted to the

SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

on

THE FEDERAL HOUSING ADMINISTRATION

July 24, 1990

Mr. Chairman, Members of the Subcommittee:

I am Phil Forest, a member of the Mortgage Finance Committee of the National Association of Home Builders, and Vice Chairman of their Single Family Governmental Subcommittee. I greatly appreciate the opportunity to appear before the Subcommittee to discuss the future role of the very cornerstone of the nation's housing policy, the Federal Housing Administration's (FHA) single family Mutual Mortgage Insurance program. We commend the Subcommittee's professional staff, both the majority staff and the minority staff, for their untiring dedication in support of enactment of major long-term housing policy.

The more than 157,000 member firms of NAHB and their more than one million employees are strongly supportive of the foresight and leadership Congress displayed over 50 years ago in establishing FHA to advance homeownership opportunities. Further, more than 15 million families are witness to this fact, having achieved homeownership, many for the first time, as a result of the opportunities offered by FHA.

NAHB strongly supports, first and foremost, the continued financial solvency of FHA. A strong, viable FHA is the first step if this agency is to continue its housing mission and purpose. We also strongly support the continued broad availability of FHA-insured financing for prospective homebuyers. At times it may appear that there is a tension between those goals. However, with careful planning we think both can be met. We therefore believe that any major structural changes in the program should be weighed carefully and result from the process of open hearings and debate through the normal legislative process.

Until recently, the FHA operated without loss. Beginning with fiscal year 1988, however, the fund began to experience losses. As a result, the Administration commissioned a report on the solvency of the fund and contracted with the accounting firm of Price Waterhouse.

The Price Waterhouse study reports an erosion in the capital of FHA's Mutual Mortgage Insurance Fund (MMIF), and outlines a number of alternative program changes to reverse this trend. It is the responsibility of Congress and the Administration to determine how best to restore the FHA program reserves, in order to provide a cushion against adverse future events, as well as to maintain FHA's ability to help families to achieve homeownership. NAHB welcomes the opportunity to work with the Members of this Subcommittee on this goal.

Insurance Premium Structure

In 1983, the Office of Management and Budget (OMB) spearheaded a change in the structure of the FHA mortgage insurance premium (MIP). Instead of the homeowner paying an insurance premium of 50 basis points, or one-half of one percent, annually on the outstanding mortgage balance, as had been the practice since 1934, the homeowner was required to pay the premium in one lump sum -- up-front, at time of closing. The change was not intended to improve the actuarial soundness of FHA. Instead, it provided a way to achieve a short term reduction in the federal budget deficit. The government received additional revenues, and needed to borrow less in the marketplace.

In order to make the up-front premium palatable to homebuyers and to the Congress, it was agreed that homebuyers would be allowed to finance the up-front premium even if this made the loan larger than the value of the property. This one decision greatly increased the risk of default and the loss to the insurance fund in the event of default. There is no question that this policy has contributed to the losses experienced by the fund.

HUD and OMB have argued that the up-front premium is equivalent to homeowner's equity, citing the fact that a portion is refundable upon prepayment of the mortgage. It is wishful thinking to believe that the borrower regards the insurance premium as equity in deciding whether to default. We strongly believe that OMB and HUD must recognize reality. The actions by the previous Administration were not sound housing policy; continuing the up-front premium, and pretending it is equity, is equally unsound now.

FHA reforms should be based on actuarial soundness while providing continued access to homeownership, and should not be based on short-term budgetary considerations. NAHB strongly supports a return to a periodic premium coupled, if necessary, with a smaller up-front premium which may be financed.

Risk Based Premiums

Perhaps the most troublesome portion of the Administration's FHA reform proposal is that of establishing a risk-based premium surcharge on all mortgages with downpayments of 10 percent or less. Indeed, HUD proposes to place the full burden of restoring the depleted insurance reserves on the future home purchasers who experience the greatest difficulty in obtaining mortgage financing.

Under HUD's proposal, the larger the downpayment percentage, the shorter the period a family pays an annual premium. Such an approach abandons an important principle of FHA. Under current law, all homebuyers pay the same percentage, thus balancing risk within the fund. This concept remains sound public policy.

The basic purpose of FHA is to increase homeownership opportunities. To set higher fees for those at the lower end of the homebuying spectrum is to say, in effect "the less you have the more we want." The fee proposed for borrowers with low downpayments is effectively more than twice the fee for those who put more than 10% down. The price to walk through the door to homeownership should be the same for all who can pay the basic downpayment.

Some have argued that a uniform premium structure would price FHA higher than private insurance plans for low-risk borrowers and would contribute to an adverse concentration of only the higher risk mortgages in FHA. However, FHA has always operated with one premium for all borrowers and that premium, for many years, was twice what the private insurance companies charged. Yet, FHA continued to insure a broad spectrum of loan-to-values. There are numerous reasons why this has been true.

FHA offers borrowers a number of advantages not available to borrowers using private mortgage insurance. Some of the most notable are:

- o the ability to finance most of the closing costs,
- o the ability to finance the up-front insurance premium,
- o constant and consistent availability of mortgage insurance in all parts of the country,

- an assumable loan than can make resale feasible during periods of elevated interest rates,

- a nationally recognized secondary market that provides loan originators the most efficient and cheapest means of replenishing their loanable funds, translating into the lowest possible borrowing costs to the homebuyer, and

- realistic and flexible underwriting guidelines that permit the greatest access to homeownership while protecting the fund and families from ill-advised purchases.

NAHB strongly opposes the concept of risk-based premiums for FHA's single family mortgage insurance program.

Distributive Shares

The MMI fund was designed to be a self-supporting fund with dividends, or distributive shares, paid to borrowers out of any surplus. Distributive shares have been paid, as a matter of practice, based on the performance of a given year's book of business. Lately, as we have seen, the fund has been losing money, but $140 million a year in dividends continue to be paid.

Mr. Chairman and Members of the Subcommittee, there exists no logic, much less sound business practice, for continuing to pay dividends from a fund that is reporting losses.

NAHB strongly supports discontinuing this practice. Distributive shares should not be paid unless the fund, as a whole, achieves an adequate level of reserves.

Premium Refunds

Another current practice is for FHA to pay refunds on the up-front MIP to those who prepay their mortgages. These refunds are in addition to the payment of distributive shares.

Premium refunds are based on the age of the loan at the time of prepayment. These refunds, in our opinion, do not adequately reflect risks in the early years of the mortgage, nor do they reflect the full costs of providing the insurance. To correct this flaw in the current system, NAHB strongly supports a change to reduce refunds paid.

Closing Costs

The Administration's proposal with respect to financing closing costs would impose a high burden for cash-short first-time buyers. The proposal would require two-thirds of the closing costs to be paid in cash at the time of settlement (see exhibit 1).

NAHB recognizes that a loan exceeding the property value presents unacceptable risks. Such loans have been insured primarily because of the introduction of the up-front premium, as we discussed earlier. Rather than changing the rules regarding closing costs, there should be an overall limit on the loan to no more than the property value, and this limit should be phased in along with a reduction in the up-front premium and reintroduction of a periodic premium.

Maximum Mortgage Limits

We strongly believe that FHA mortgage limits should be indexed to reflect true housing prices in all market areas. Rather than debate the precise level of the high-cost limit each year, we recommend a permanent link to a recognized indicator of national house price inflation. NAHB also recommends the continuation of a 95 percent of median limitation as a means of determining local ceilings below the high-cost ceiling. We would suggest that the high cost limit should be capped at 85% of the secondary market's conforming loan limit.

Not allowing the high-cost limit to track inflation, in effect, excludes many families who happen to live in markets with high housing costs. By denying them FHA insurance, we deny many of them the opportunity to own a home.

It is also worth noting that both FHA and VA experience, with loans below area median, shows that larger loans are less risky than small ones. This is true even where loan-to-value ratios have been equivalent (see exhibit 2).

NAHB believes the time has come to minimize the obstacles to FHA mortgage insurance in all markets. Indexing the maximum mortgage limits would help achieve this equitable goal.

SENATE ACTION

As adopted by the Senate, the burden of rebuilding FHA's reserves will fall on those families that make the lowest downpayment. The Senate bill calls on those least able to pay to prop up the fund all by themselves. Those with existing mortgages don't pay more. In fact, those families who put 10 percent or less down in the future, must generate nearly one billion dollars more in reserves each year than is now generated.

Further, it completely begs the question of the present 3.8 percent insurance premium paid up front at closing, but which may be financed.

The result is to continue to allow the approval of mortgage loans in excess of property values -- 100.8 percent on loans over $50,000 and 101.8 percent on loans under $50,000 - a slight decrease from current law, but a level, which we, nonetheless, believe will continue to place the fund at an unnecessarily high risk.

Mr. Chairman, we note in the legislation that the maximum loan to value permitted is 97 percent on loans over $50,000 and 98 percent on loans under $50,000. But, this language becomes meaningless as the 3.8 percent up front premium is defined as equity and is therefore allowed to be financed above this limit. The goal of lower LTVs is laudable, however, the definition of premiums as equity is deplorable.

Mr. Chairman, we are looking at the potential of denying homeownership opportunities many families as a result of the actions taken by the full Senate to reform FHA along the lines proposed by the Administration.

Further, the practical effect of Senate action on future homebuyers, will be significant. The Administration's proposal would require the average family to come up with half-again as much cash to buy a home. Relying on the approach used by the Government Accounting Office (GAO), we believe that many FHA borrowers make downpayments of five percent or less could be kept out of the market. In 1989, 41 percent, or 215,000 families of the 30 year endorsements (leaving investor loans out of the base) made downpayments of five percent or less. Using HUD, OMB, and Congressional estimates for 1990 activity, 290,000 families are expected to enter the program with downpayments of five percent or less under existing insurance pricing. Conservatively, we believe that a third, or approximately 90,000 families, of the five percent downpayments and below could be affected to the point of being denied homeownership. Obviously, this number could be a lot higher.

Under the Senate passed proposal, high loan to value borrowers (those making downpayments of less than 10 percent) will be hit twice.

First, their cost of mortgage insurance will increase anywhere from 37 percent to 91 percent due to the extra half of one percent annual charge. Second, the out of pocket costs will greatly increase about 50 percent.

HOUSE OF REPRESENTATIVES ACTION

As the Chairman and Members of the Subcommittee are aware, Representatives Vento (D-MN) and Ridge (R-PA) have initiated a proposal (H.R. 5266) in the House of Representatives which we support, and which embodies provisions that encompass many of the ideas described above.

The Vento-Ridge proposal would ensure the safety and soundness of FHA without unduly penalizing homebuyers. In summary, Vento-Ridge provides the following:

- Strengthens the FHA insurance premium by returning to a "pay-as-you-go" structure. The current up-front fee of 3.8 percent of the loan would be changed to require 1.35 up-front, plus a .6 percent fee paid over the life of the loan. This change would be phased in over a five year period;

- Requires a minimum capital standard of 1.25 percent to be attained within 24 months and a two percent capital standard to be attained within 10 years;

- Discontinues the payment of distributive shares until the MMIF is actuarially sound (achieves the capital standard of 1.25 percent);

- Requires, beginning in 1993, that no mortgage be allowed to exceed the market value of the property; and

- Reduces the rebate of unearned premiums for loans currently on the books. All premiums would be "earned" when paid and a portion would no longer be rebated to those who prepay their loans.

Conclusion

In conclusion, it should not be overlooked that the primary reason for the recent losses to the FHA fund is a budget gimmick implemented by the past Administration that permitted FHA to finance over 100% of the value of houses being sold, along with gross mismanagement at HUD. These unfortunate and unwise actions combined with the economic downturn in the "oil patch" states are the major contributing reasons why FHA is now experiencing losses. The corrective measures, which recently passed the Senate, unfortunately, placed the burden on those least able to pay, the first-time home buyer having precious little savings to apply for a downpayment At a time when we are experiencing the most serious decline in homeownership rates in U.S. history, Congress and the Administration should look at measures designed to encourage, rather than discourage, homeownership.

Accordingly, Congress should support the Vento-Ridge FHA proposal originally suggested as a sound measure by the Price Waterhouse report. In addition, we believe it is imperative that the final housing bill include the following provisions from H.R. 5157: the National Housing Trust and the Homeownership Made Easier (HOME) provision.

Again, Mr. Chairman, we greatly appreciate the opportunity to appear before the Subcommittee on the future role of FHA, and we look forward to working with the Subcommittee as the legislative process continues to move us closer to enactment of major long-term housing policy. Your commitment to achieving this worthwhile goal is both noted and greatly respected by all.

Exhibit 1

THE IMPACT ON AN AVERAGE FHA HOME BUYER OF VARIOUS REFORM PROPOSALS

	CURRENT LAW	ADMINISTRATION'S PROPOSAL	VENTO/RIDGE 1ST YEAR	VENTO/RIDGE 2ND YEAR	VENTO/RIDGE 3RD YEAR
HOME PRICE	$70000	$70000	$70000	$70000	$70000
CLOSING COSTS FINANCED	2100 (100%)	700 (1/3)	2100 (100%)	2100 (100%)	2100 (100%)
ACQUISITION COST	72100	70700	72100	72100	72100
DOWNPAYMENT	3105	3035	3105	3105	3105
LOAN BEFORE UPFRONT PREMIUM	68995	67665	68995	68995	68995
INSURANCE PREMIUM	2622 (3.8%)	2571 (3.8%)	2553 (3.7%)	1794 (2.6%)	931 (1.35%)
LOAN AMOUNT	$71617	$70236	$71548	$70789	$69926
CASH REQUIRED TO CLOSE					
DOWNPAYMENT	3105	3035	3105	3105	3105
CLOSING COST	--	1400 (2/3)	--	--	--
TOTAL	$3105	$4435	$3105	$3105	$3105
MONTHLY PAYMENT					
PRIN. PLUS INT.*	628	616	628	621	614
MORT. INS. PREM.**	--	29 (.50)	12 (.20)	20 (.35)	29 (.50)
TOTAL	$628	$645	$640	$641	$643
Debt/Price Ratio	102.3%	100.3%	102.2%	101.1%	99.9%

* Assumes a 30 year fixed rate mortgage at 10 percent interest.

** This represents an approximate monthly amount during the first year. This amount will decrease over time.

Exhibit 2a

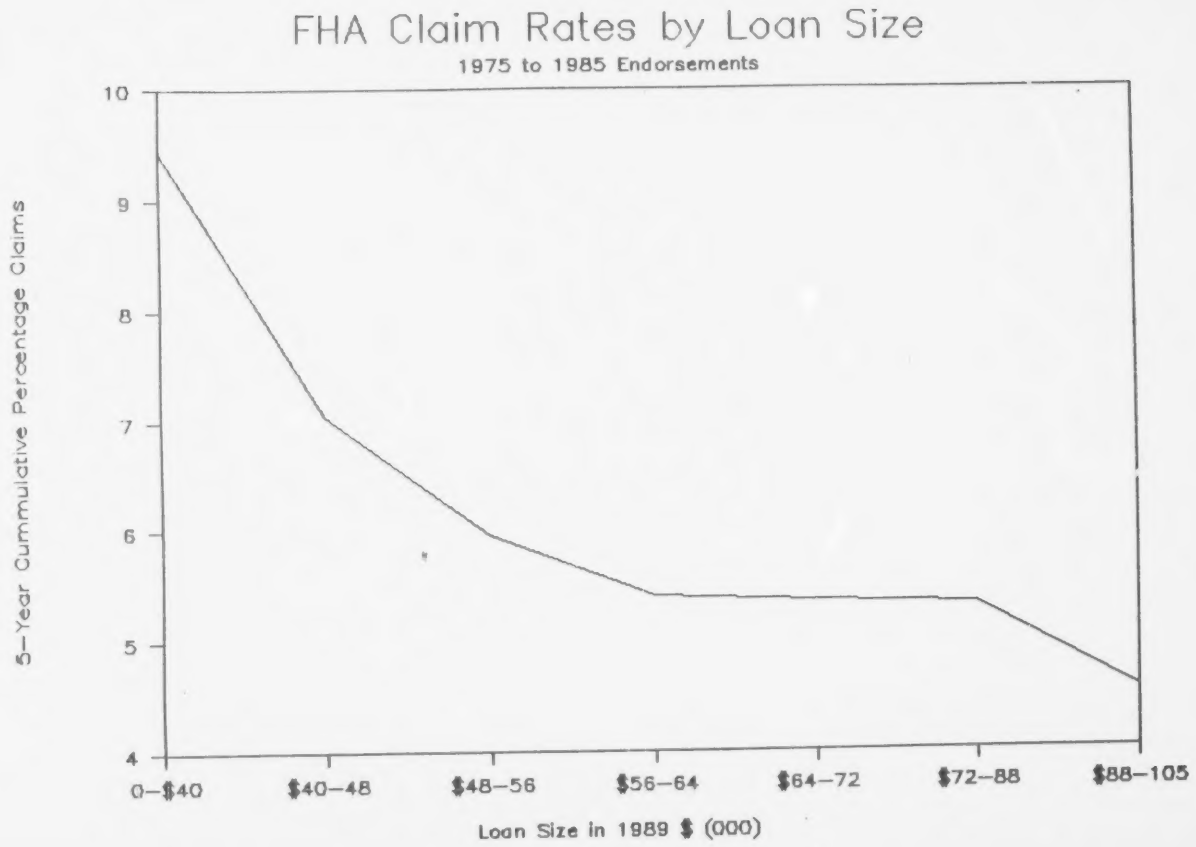
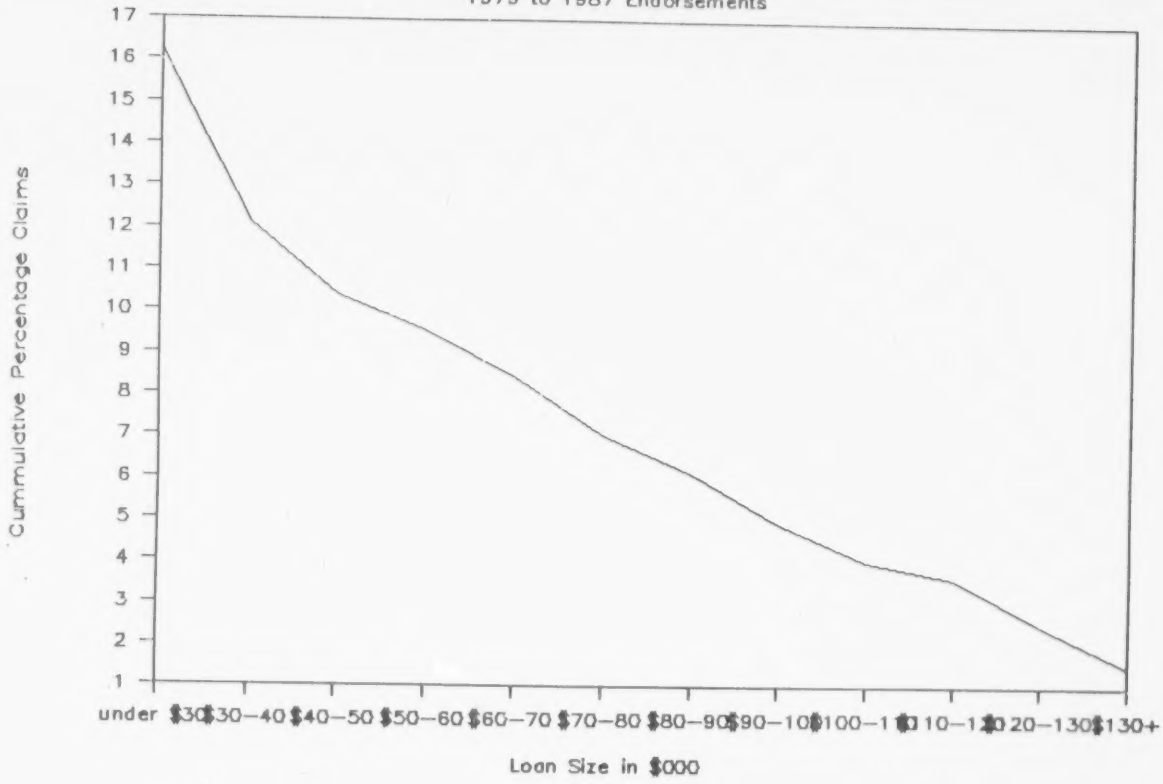

FHA Claim Rates by Loan Size
1975 to 1985 Endorsements
5-Year Cummulative Percentage Claims
10
9
8
7
6
5
4
0-$40
$40-48
$48-56
$56-64
$64-72
$72-88
$88-105
Loan Size in 1989 $ (000)

Exhibit 2b

VA Claim Rates by Loan Size

1979 to 1987 Endorsements